HOST GOVERNMENT CONTROL OF MNEs:
SQUIBB EGYPT CASE STUDY

Being a Thesis Submitted for the Degree
of Ph.D. in Accounting
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By

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Abstract

The socio-economic development of many developing countries depends heavily on the flow of foreign capital brought about by multinational enterprises' (MNE's) activities. However, there is evidence that the actual benefits derived by host countries from these enterprises are often less than expected. Accordingly, this clearly supports the need for an effective government control framework to increase the benefits of these foreign enterprises to the host country.

This study therefore examines, both theoretically and empirically, the types of controls operated at present, with a view to establishing an appropriate framework for future control. A host government control framework consists basically of two complementary and integrated control processes: an entry control process to ensure that only those foreign enterprises which will be of benefit to the national economy are approved; and an operational control process to check that the project's operations are carried out in accordance with approved plans. In practice, the control mechanism focuses on the role of local accounting and reporting systems, and the role of the government auditor rather than other government bodies responsible for applying the control process.

Egypt has been selected as the focus for the study, since many MNEs operate there under the open door economic
policy, and it is believed that the many incentives given to attract foreign investment have allowed MNEs to gain greater benefits than they give to the country. Squibb Egypt, a foreign subsidiary in the pharmaceutical sector, is taken as a case study, in view of the importance of the sector to the Egyptian economy, and its increasing domination by foreign enterprises. Data have been collected through interviews from government departments and agencies dealing with MNEs in Egypt and Squibb Egypt. The result of the case study has indicated that Squibb Egypt has made only a modest contribution to the economy. This deficiency is attributable to the lack of the control system currently operated by the Egyptian government over MNEs. This provides a strong case for arguing that the adoption of a sound government control system is essential to alleviate many of the problems and deficiencies raised in this study, and to meet both national objectives and those of foreign enterprises.

The research is divided into three main parts. The first, containing two chapters, examines the general relationship between a host government and the MNE, and describes a control framework model which could alleviate the problems arising from MNE entry and operations within a host country.

Part two, which also contains two chapters, presents an overview of foreign investment in Egypt from 1952-1987, reviewing the open door policy and appraising its impact on the economy, and the control system currently operated by
the Egyptian government.

The empirical research is presented in the six chapters of part three, which examines the development of Squibb and the controls exercised over it, and evaluates the company's financial performance and its contribution to the Egyptian economy. Finally, recommendations are made to improve the evaluation and control over MNEs by host governments, with a view to maximising the benefits obtained from them.
I would like to dedicate this work
To the Memory of my Father
and
To my Family in Egypt
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Abbreviations

A.R.E  Arab Republic of Egypt
A.R.R  Accounting Rate of Return
A.F.R.O.S.A.I African Supreme Audit Institutions
C.A.A  Central Agency for Auditing
C.A.P.M.A.S Central Agency for Public Mobilisation and Statistics
C.M.A  Capital Market Authority
E.E.C  European Economic Community
E.U.A.S Egyptian Uniform Accounting System
F.A.D  Financial Analysis Department
F.I.F.O  First in First Out
F.I.T.O  Foreign Investment Tax Office
F.U.P.E.D Follow - Up and Performance Evaluation Division
G.A.F.I  General Authority for Foreign Investment
G.C.A  General Companies Administration
G.D.F.C  General Directorate for Foreign Currency
G.O.D  General Organisation for Drugs,
G.N.P  Gross National Product
G.D.P  Gross Domestic Product
I.A.S.C  International Accounting Standards Committee
I.C.F.T.U  International Confederation of Free Trade Unions
I.C.S.I.D International Centre for Settlement of Investment Dispute
I.F.A.C  International Federation of Accountants
I.M.F  International Monetary Fund
I.R.R  Internal Rate of Return
K.P.M.G  Klynveld Peat Marwick Goerdeler
L.E.  Egyptian Pound
MNEs  Multinational Enterprises
MNCs  Multinational Corporations
N.P.V  Net Present Value
N.S.V  Net Social Value
O.E.C.D  Organisation for Economic Cooperation and Development
O.D.E.P  Open Door Economic Policy
P.C.N.P  Permanent Council for National Production
P.F.U.D  Planning and Follow-Up Department
R & D  Research & Development
S.E.C  Securities and Exchange Commission
T.A  Tax Administration
U.K  United Kingdom
U.N  United Nations
U.S.A  United States of America
INTRODUCTION

IDENTIFICATION OF THE PROBLEM

Since the appearance of multinational enterprises (MNEs) in host developing countries, numerous theoretical and empirical studies have been undertaken dealing with various problems related to their operations. These studies can be classified into two broad areas of analysis. The first deals with the factors that attract the flow of foreign direct investment based on incentives created for this capital. The socio-economic development of most of these countries depends heavily on the flow of foreign capital brought about by MNE's activities. This may be because of lack of local capital for investment, shortage of technology, lack of foreign exchange, persistent balance of payments deficit, lack of local resources, and/or failure to use the country's resources to the best advantage.

The second area deals with the effects of MNEs on the host countries. The quantifiable effects relate to many areas including increased national production and output, employment, and the balance of payments. However, there is clear evidence from these studies that the actual contribution of MNEs to socio-economic development of host countries has been less than hoped by the host governments. Undoubtedly, MNEs have attempted to maximise their profitability by increasing their strength in these
countries and it has not been possible to check their growth. As a result, host governments are becoming sensitive to the operations of these enterprises, and it is evident that there is a need for some form of control system to increase the benefits of such enterprises to the host country's development.

In order to determine an appropriate control framework it is first necessary to ascertain what controls, if any, are practised at present. Are they adequate to control all necessary aspects of MNE activity? If they are inadequate, what are the alternatives?

Most of the existing studies on this subject have concentrated on economic, legal, political and managerial control aspects or cost/benefit analysis, ignoring the role of accounting and reporting systems as a device for facilitating the investigation, control and evaluation of MNE's activity by host governments, at entry and during operation. The studies have also failed to consider the appropriate criteria for entry and operational control systems and for measurement of the contribution of these enterprises. Nor have the government auditor and other government bodies been recognised as organs of control with access to the books and transactions of MNEs.

As far as developing countries are concerned, it is appropriate to control MNEs by means of direct access to the books by the host government. In other words, it would be essential for host government to have access to the internal
records of local subsidiaries to bring them under close supervision and make them more beneficial for the country. This new control approach is gaining increasing support in view of the dominant position of MNEs in host developing countries. Several United Nations reports have clarified and supported this approach, stating that adequate and effective host government control should be exercised through accounting and reporting techniques and based on a group of criteria such as value added, employment, and balance of payments effects. In addition, the process of control will rely upon the host country’s government auditor and his staff in order to compare the actual performance with that proposed (United Nations, 1979, 1984). For this reason, the UN council decided to establish an Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting to pursue work in this area.

Therefore, appropriate methods and procedures by which a host government may monitor and evaluate a foreign subsidiary may include:

1. Examination of its feasibility study at entry from the technical, financial, and economic points of view, in accordance with criteria for project appraisal suitable for developing countries. The main purpose of this is to ensure that the new foreign project proposal is consistent with national planning objectives and will be socially beneficial.

2. Creation of a financial and administrative control system which gives host government officials access to the books of
the foreign subsidiary during the operating stage. The application of such a system should depend on the host country's own accounting system. This will not only provide information for control, but is also an essential key for evaluating a foreign enterprise's results. In other words, such a system will assist the host government to investigate and monitor the results of foreign subsidiaries and bring their operations under close supervision. The control and evaluation of foreign subsidiaries requires information which is economically realistic and comprehensive. Faulty information may lead to misleading performance evaluation and poor control.

3. Determination of appropriate measurements of performance in order to learn the real contribution of foreign subsidiaries in terms of national production and output, employment, balance of payments effects, tax revenue and rate of growth of the host economy.

To illustrate the proposed control system, Egypt has been chosen as an example of a developing country for this study for two main reasons. Firstly, the Egyptian experience may provide an appropriate case for examining the effectiveness of host government control over MNEs, since many foreign enterprises operate there under the umbrella of the open door economic policy, which was adopted in order to attract foreign enterprises to invest in Egypt. Many incentives and numerous guarantees have been offered, with limited or no restrictions and freedom of remittance of
profits and capital. This has allowed foreign subsidiaries operating under these incentives to gain greater benefits than they give to the country in terms of foreign investment.

Secondly, despite the many analyses of foreign investment in Egypt, no study has been made of the control of foreign enterprises, with the exception of a recent study, focusing on the nature of the control measurements in industry sector rather than their effectiveness (Hewaidy, 1988).

Squibb Egypt, a foreign subsidiary in the pharmaceutical sector, was selected from the foreign subsidiaries operating in Egypt as a case study for the present work. This is because the pharmaceutical industry in Egypt is becoming increasingly dominated by foreign enterprises, whose sales and profits in many cases are increasing faster than those of nationally owned companies, giving rise to remittance of profits by illegal means. Thus, this study seeks to give concrete answers to the following questions:

1. What are the characteristics of the Egyptian governmental control structure, laws and regulations governing foreign enterprise investment? How do such characteristics affect the flow of foreign investment at entry and during operation?
2. What is the actual process of Egyptian control at entry
3. How did Squibb Egypt reach a decision to invest in Egypt?
4. Was the feasibility study required by the code of foreign investment carried out for this subsidiary?
5. Was the feasibility study carried out by the parent company or a private external auditor?
6. Should the government auditor have the right to investigate feasibility studies?
7. What are the criteria used to measure the company's decisions in terms of
   a. Gross national product (value added)
   b. Employment
   c. Balance of payments
   d. Government revenue from taxes?
8. What techniques should be used to measure performance against the criteria previously adopted at the time of the decision to invest?
9. What kind of reports are needed by Government bodies to exercise control?
10. To whom should they be submitted?
11. What is the role of the government auditor in investigating these reports?
12. What is the appropriate accounting system to help government bodies to evaluate the actual contribution?
13. What other types of policies are used to regulate and control foreign subsidiaries?
14. What is the actual contribution of the subsidiary
to the Egyptian economy?

It seems reasonable to suggest that effective government control is required to make foreign enterprises more beneficial to socio-economic development. Therefore, the above questions will represent the essential outline of this research, since most of them have never been asked in the Egyptian environment.

THE OBJECTIVES OF THE RESEARCH

On the basis of the above argument, the main problem facing host developing countries is the need for an adequate control system to measure accurately the performance of foreign enterprises at entry and in their operation.

For this reason, this study focuses on the appropriate framework for a control system that can be exercised over MNEs by host governments which are developing countries. Integration between the control criteria and responsibility for the control process will be considered, together with a clear specification of both MNEs and host country's objectives. The essential control function will be the comparison between the enterprise's actual performance and its planned objectives. To achieve this, appropriate financial and non-financial information must be disclosed to facilitate control and evaluation.

Another objective is to highlight the effectiveness of
the actual control processes exercised by the Egyptian Government over the entry and operation of foreign enterprises generally, and Squibb Egypt Company in particular, to illustrate how the government control system works, how efficient it is, and to what extent foreign enterprises accept such evaluation of their performance in relation to the country's objectives. Finally, an attempt will be made to find out whether the system needs development if it is inadequate, ineffective, and/or insufficient to measure the performance of a foreign subsidiary.

First, the actual control system will be critically examined in terms of the techniques used to evaluate the feasibility study of Squibb Egypt. Special attention will be paid to the analysis of its costs and benefits in accordance with the formal criteria used for the pharmaceutical sector. An examination of the internal records and all transactions will be made, taking into account the disparity between the accounting systems of the two sides. Attention will be paid to techniques used to transfer funds and profits, including transfer pricing and leading and lagging. Comparison between the feasibility study objectives and the actual performance will also be made. These steps may lead to recognition of deficiencies in government control over the subsidiary and appropriate remedies may be identified, which would facilitate the economic development of the country.

On the basis of the above discussion, the objectives of
the research can be summarised as follows:
1. to clarify the main reasons for the need for a host government control framework;
2. to suggest a more effective system of government control which might enable the Egyptian government to increase the benefits and reduce the cost of foreign enterprises investment in the future;
3. to highlight the major developments in foreign investment in Egypt and their effects on the economy since the 1950s;
4. to analyse the actual framework of control exercised by the Egyptian government over Squibb Egypt at entry and during operation; in addition to investigate whether Squibb Egypt's investment was in line with the social and economic objectives of Egypt.
5. to measure the actual impact of Squibb Egypt on national product, employment, balance of payment, government revenue and the overall growth of economic output;
6. to identify appropriate remedies in the light of the control system proposed above.

The above objectives will be met by means of research questionnaires and interviews with Squibb Egypt management and government officials.

FOCUS OF STUDY

The focus of this study is the examination of government control over Squibb Egypt, which operates in the pharmaceutical sector. Squibb Egypt was selected as a case study from among the foreign enterprises which have invested in Egypt in recent times, to show how the Egyptian control
system works with foreign subsidiaries and the extent of their contribution to the economy. The duration of the study is 1984-1987.

The selection of Squibb Egypt as a case study and an example of MNEs in Egypt was made after a pilot study in Egypt in 1985, which investigated the forms of MNEs, their relative importance to the economy and their distribution by sectors. The reasons for the choice were as follows:

First: The pharmaceutical industry represents about 20% of Egypt's economic plans, as well as being the leading sector in its development process, and consequently a wide range of policies in the national plans are directed towards developing this sector.

Second: During the last fifteen years many foreign enterprises have entered this sector.

Third: At least 50 per cent of the sector is dominated by foreign enterprises, including joint ventures.

Fourth: Out of seven foreign enterprises, two are foreign wholly-owned, though one of them are still in the process of being established.

Fifth: The company is set up under complete foreign ownership.

Sixth: There has been a lack of empirical studies on the control of foreign subsidiaries in this sector.

Seventh: The researcher's familiarity with the economic, political, social and accounting environment was of help in collecting the data required for the study.
For the above reasons, therefore, it seemed desirable to focus on Squibb Egypt in the pharmaceutical sector as a case study for the present study.

LIMITATIONS OF THE RESEARCH

In view of the research objectives, two interrelated approaches can be followed to answer the question of why various aspects of foreign enterprises' decisions should be monitored by government officials in host countries. The first is the theoretical approach, which produces a framework to explain a particular control model in operation. To determine this new framework, a great deal of literature on host governmental control systems has been gathered from British libraries.

The second approach is the field study. Some empirical studies have been conducted to test how host countries carry out control procedures by means of laws, regulations and economic policies; but, surprisingly, nothing has been written about a control system based on direct access to the books of foreign enterprises and monitoring of their financial and economic impact on the country. This research has confined its investigations to Squibb Egypt and this should be borne in mind when generalising from the research.

Thus, to conduct this case study, data about the control process and evaluation techniques exercised over Squibb Egypt at entry and during its operations have been supplemented by interviews with government officials and
Squibb Egypt’s management.

RESEARCH METHODOLOGY

This section is divided into two main categories as follows:

1. Sources of Data

The main types of data required for this study are:

1. Data about the open door policy and foreign investment in general and Squibb Egypt in particular; these have been collected from the Planning Ministry, the Economic Ministry, the General Foreign Investment Authority, the General Companies Administration, the Central Agency for Auditing, the General Organisation of Drugs, and the Central Agency for Mobilisation and Statistics. Data also have been collected about national planning, Gross National Product, taxation, foreign exchange, employment, etc. Furthermore, some investigations have been made regarding the code of foreign investment, regulation, policies, rules, the Egyptian accounting system, auditing, planning, techniques of control and performance evaluation, the level of communication and coordination between government officials, and processes of decision-making. Uncertainty and changes within foreign enterprises and in their international environment have also been taken into consideration.

2. Comprehensive data were collected from Squibb Egypt about its historical development, profitability, feasibility study appraisal, implementation, control devices and performance evaluation. These data were derived from Squibb Egypt’s
annual reports between 1984-1987 as well as from interviews with the subsidiary's management. These data can be classified into three categories:

1. general information about the nature of the subsidiary, ownership structure, source of finance, organisational structure, etc.;

2. data about the entry stage which includes the feasibility study report, application procedures, and methods of evaluation.

3. data about the operation stage, which includes two kinds of information as follows:

A. financial information based on published and unpublished reports and statistics. These include income statements, balance sheets and funds statements.

B. non-financial information concerned with, for example, investment programmes, organisational structures, the number of employees and their wages, production methods and policies, purchase policies, accounting policies, and transfer pricing policy.

The foregoing data have been analysed in order to identify the system of control exercised by the Egyptian government over Squibb Egypt both at entry and during operation.

2. Data Collection Method

Data required for the purpose of this study were collected by means of interviews relying on a questionnaire and check list prepared for this purpose and addressed to
both government officials and Squibb Egypt management (see Appendices 1 & 2).

The main objectives of each interview with government officials and Squibb management were twofold:
1. to gather information and reports whenever possible, from the subsidiary and government departments for study purposes;
2. to investigate the control and evaluation techniques applied to the enterprise at entry and during its operations, and the enterprise’s performance.

The interviews were divided into two parts, each part dealing with one point and serving one objective. In the first part, which included a questionnaire as a guide, Egyptian government departments were asked about their tools and policies for controlling foreign enterprises in general and Squibb Egypt in particular, from entry up to performance evaluation. In other words, the main objective of this part was to determine the potential contribution of foreign enterprises in general and Squibb Egypt in particular to the Egyptian economy, the process of approving new foreign investment proposals, what criteria are used to accept/reject proposals, the process of control over foreign enterprise operation, and the extent to which actual benefits have been maximised to meet Egyptian economic objectives.

This part was divided into four sections. The first section contained general questions about the open door policy and foreign investment in Egypt. The aim of this
section was to obtain information about the policies and regulations which are issued regarding foreign enterprises, volume, size, amount of foreign investment and the forms of foreign investment.

In the second section, questions were asked about government control at the entry stage. The aim of this section was to obtain information about the objectives of government in attracting MNE’s, the process of approving the entry of foreign enterprises, the criteria used to approve new projects, the information required from foreign enterprises and who exercises control.

In the third section, questions were asked about government control during the operating stage. The objective of this section was to obtain information about the process of evaluating the results of foreign enterprises, the methods of control, the problems of control procedures, who exercises control and the role of the Central Agency for Auditing, the Ministry of Planning and the General Foreign Investment Authority in controlling foreign enterprises; the role of the General Organisation of Drugs was investigated and suggestions were invited for further measures of control.

In the final section, questions were asked about the actual contribution of MNEs and Squibb Egypt in particular to Egyptian economic objectives. The aim of this section was to measure the actual effects of Squibb Egypt in terms of value added, government revenue, employment, balance of
payments, and the rate of growth.

With regard to the second part of the interviews, with Squibb Egypt management, the check list was divided into two sections. The first section, headed "General Information", was designed to obtain information about the nature of the company, its location, the ownership structure, financial structure, source of finance, source of raw materials, quality of control, managerial organisation, and its internal control system. The aim of this section was to ascertain how the subsidiary was set up, how long it took, how the ownership structure affects the control and management of the subsidiary, and the sources of finance.

The second section, headed "Control at Entry and During Operation", was designed to obtain information about the control and performance evaluation exercised by the Egyptian government. This section was divided into two sub-sections as follows:

1. Questions were asked about control at entry time. The aim of this section was to provide information related to the feasibility study including data about technical aspects, financial and economic aspects, and the body responsible for preparing the feasibility study, investment plans, government control system at entry time, and the general objectives of the economy.

2. Questions were asked about the operating stage and performance evaluation. The aim of this section was to identify the effectiveness of the actual financial and non-
financial control exercised by government officials. It was necessary to obtain exact figures for the expected and actual financial and non-financial results. In addition this section aimed to measure the effects of the subsidiary in terms of value added, employment, balance of payments, and rate of growth.

ORGANISATION OF THE RESEARCH

The research is divided into three major parts in addition to the introduction and the conclusions. The first part examines the general relationship between a host government and the MNE, and describes a control framework model which could alleviate the problems arising from MNE entry and operations within a host country. Chapter one defines MNEs and explores their relationship with host developing countries, with particular reference to areas of flow of investment and types of activities. The economic impact of MNEs is discussed, highlighting the necessity of control, and some literature relevant to host control is reviewed, together with various international and regional control approaches.

The proposed framework for host government control of MNEs is outlined in chapter two based on the general control model widely used in the accounting literature. The model is considered as a continuous closed loop, incorporating the setting of objectives, performance evaluation, feedback of any deviation, and corrective action. Economic and financial criteria for project acceptance are discussed, and the importance of Cost-Benefit Analysis and Concession Agreement
are emphasised. Particular consideration is given to the role of government agencies, especially the government auditor, at all stages of the control process. This would involve access by the government auditor to MNE records, in order to conduct, not only financial and compliance audit, but also efficiency and effectiveness audit.

Part two of the research, containing two chapters, provides an overview of foreign investment development in Egypt, analyses its impact on the economy, and indicates the current legal framework for foreign investment, including the controls operated by the Egyptian government and the authorities and agencies whose responsible to deal with it.

Chapter three reviews the development of foreign investment in three phases: the free market economy which existed prior to 1956; the socialist phase of 1956-1973, characterised by a wave of nationalisations; and the open door policy from 1973 to the present.

Particular attention is given to the various investment laws under which foreign enterprises operate, and an appraisal is made of the major effects of foreign investment on the Egyptian economy in terms of employment, the balance of payments, taxation, and the actual contribution to national production and output.

Chapter four focuses on the controls which the Egyptian government currently places on foreign enterprises, at the entry and operational stages. The financial and economic criteria against which the investment proposals are
assessed, and the roles of the various government authorities are considered in some detail. The chapter then considers more closely the entry and operational control systems, revealing the shortcomings in the process and how they can be treated. Entry control includes the entry requirements imposed on foreign projects and the processing of the application. Operational control involves the application of financial controls, and evaluation of the project's performance.

The third part covers the empirical research conducted in Egypt, using Squibb Egypt as a case study. This part includes six chapters dealing with the influence of Egyptian governmental control techniques on the activity of Squibb Egypt. Chapter five reviews the historical development of the Egyptian pharmaceutical industry from its origins up to 1986. It also describes the Squibb Corporation's background, with particular reference to the development of the Egyptian subsidiary.

The sixth chapter reviews the entry control process operated by the Egyptian government at the time of the project's proposal. Special attention is given to an evaluation of the project's feasibility study in terms of technical, financial and economic aspects, and further suggestions have been offered for the process to better meet national objectives.

Chapter seven opens the discussion of the control devices used by the Egyptian government over Squibb Egypt during operation in the light of the control framework.
previously proposed. The effectiveness of financial control
techniques is discussed, with particular reference to
information disclosure, financial audit, and the
determination of transferable profits and tax liability.

Chapter eight looks at the administrative control
process. The role of various government agencies in
planning, production, quality control and employment
policies is critically examined.

In chapter nine, a close examination is made of
Squibb’s financial performance. financial ratios are used to
compare Squibb’s performance for each of the years under
study, and the subsidiary’s performance in relation to the
industry as a whole is analysed.

Chapter ten centres on the economic performance of the
subsidiary from the government point of view. Its aim is to
highlight the company’s real contribution to the Egyptian
economy in terms of value added, employment, and balance of
payments.

The conclusions of the study are discussed in chapter
eleven, and some recommendations made to improve the control
system and performance evaluation techniques exercised by
the Egyptian government at entry and during the operation of
MNEs in Egypt. Although this study is essentially concerned
with the case of Egypt, a similar approach may be applied to
other developing countries.
Part I

Governmental Control Framework
1.1 Introduction

This chapter focuses mainly on a review of the literature relevant to host government control of multinational enterprises' (MNEs) activities. To this end, the first section defines MNEs, examines their historical background and outlines theories related to them. In the second section, their relationship with host nations, particularly the areas of flow of investment and types of activities will be reviewed.

The chapter also discusses the economic impact of MNEs upon host developing economies and the need for effective control by the governments of those countries. Finally, the literature relevant to host government control is reviewed, together with various international and regional control approaches. These will be examined in order to design an appropriate theoretical framework of host government control in the light of the accounting literature.

1.2 Defining the Multinational enterprise: Its history, name, and theories

Historically, the activities of MNEs were limited to trading, but gradually they started to become producers. During the second half of the nineteenth century and up to the first world war foreign investment flowed extensively from Western Europe and the US to the underdeveloped areas, due to the increasing demand for capital for development,
the absence of obstacles to movement during that period, the increase of trade between borrowing and lending countries, political stability and revolutionary developments in transport (Dunning, J., 1972, p.59 and Hertner, P., & Jonsen, G., 1986 pp.1-17).

In the wake of the first world war, the world economy witnessed a rapid expansion in international direct investment by developed countries. According to Dunning, the character of MNEs in this period differed from the previous period in two major respects. Firstly, there was expansion with a larger share in overseas subsidiaries; secondly, there was a change of direction towards new fields (Dunning, J., op.cit).

After the second world war there was great expansion by MNEs. This caused changes in world economic development, such as the changing forms of international lending and borrowing, the changing pattern of capital exports and imports, the emergence of new foreign investment ventures as the dominant form of private overseas investment and its expanding contribution to economic growth, and the apparent new approach to the private and social costs and benefits of such investment (Dunning, J., op.cit pp.67-86). Moreover, this growth was accompanied by a change in the nature of foreign direct investment, away from the vertical integration of earlier MNE's seeking foreign sources of raw materials and toward the horizontal extension of product markets (Ibid).

During the 1970's and 1980s, MNEs grew in both
developed and developing countries, dominated by the United States and European enterprises and characterised by the emergence and growth of public sector multinationals, third world multinationals and socialist multinationals (Channan, F., & Jalland, M., 1979, pp.3-4 and Lall, s., 1982, pp. 127-146).

The MNE is thus not new. What is relatively new, however, is its size and the extent to which its international operations have become interwoven from the technical, production, managerial, marketing, financial, accounting and personnel points of view. This change has raised a variety of issues, including the relationship of MNE's to both home and host countries, in terms of high rates of inflation, economic protection policies, political power and new conflicts. Therefore, host governments are trying to cope with this new phenomenon and formulate appropriate guidelines for economic control in order to secure its positive influence on the socio-economic development of the State.

Dunning has defined a multinational enterprise as "an enterprise which owns or controls producing facilities (i.e. factories, mines, oil refineries, distribution, outlets, offices etc.) in more than one country" (Dunning, J., op.cit., p.16). Perlmutter, goes further in concentrating upon the dimension of orientation, classified as ethnocentric (or home country oriented), polycentric (or host country oriented) and geocentric (or world oriented)
According to this approach, MNE's will operate in different countries under different ownership and control: it may operate via a wholly-owned subsidiary or joint-venture companies, or license an enterprise in which it has no equity at all or sell equipment, management or training programmes.

Our major attention will focus on the issue of wholly-owned subsidiaries and joint-ventures, because of their influence on foreign enterprise and decision making within the host country and the resulting interest in host government control.

A number of definitions of MNE have been given in the literature, which vary according to whether they adhere to the theory of the firm or the theory of development policy.

The conceptual framework of the theory of the firm has been organised into four approaches: the static optimising theories, the dynamic optimising theories, the behaviouralist-organisationalist approach and the appropriability theory. Baumol and Williamson concluded that the first approach concentrates strongly upon explaining the firm's growth and expansion, which depends upon managers behaviour towards markets and resources, and profit maximisation through increasing sales. They also stressed the separation between ownership and management, showing how ownership, whatever its form, has an influence on the firm's financial, economic and decision-making power (Baumol, W., 1959 pp.45-91 and Williamson, O., 1964).

Another approach to the theory of the firm has been
developed by Penrose and Marris, who criticised the preceding approach for its neglect of the growth of the firm over time (Penrose, E., 1959 pp.1-127 and Marris, R., 1964 pp 43-102). Their approach is that the growth of the firm should be reviewed internally and externally, as it relies not only on internal processes but also on external conditions.

A point of similarity with the first approach is its focus on the importance of separation of ownership and management, on the ground that the activities of MNE's are more sophisticated than those of traditional business, and their development and investment require good planning by a well-supported management team. Therefore, the authors emphasise the role of management more than financial matters in their analysis of the growth of the firm, which depends on strategy, planning, managerial efficiency, and the diversification of production, which involves the need to create new markets.

Another important approach to the theory of the firm is Aharoni's study, (1986, pp.10-11) which applies the behavioural organisational approach to MNEs. His main concern is the decision-making process with regard to foreign investment abroad. He emphasises that the decision should be subject to full information about new investment opportunities and other factors such as the host country environment, including its legal system, government attitudes, political stability, the sociological and
cultural background, location strategy and size of market (Ibid).

Finally, the "industrial organisation approach" or "appropriability theory" has been developed by many authors such as Vernon, Caves, Hymer, and Magee. These authors have concentrated on two points: the structure of industry and the creation of technology (Magee, P., 1977, pp.297-321). This approach explains how the foreign enterprise is able to compete with national firms, in spite of the latter having considerable power in their countries, including knowledge of the local market and business conditions. These MNE's compete against domestic firms by their technology, their access to sources of finance, their use of transfer pricing systems, their avoidance of host government control and so forth.

The second theory applicable to MNEs is the theory of development policy, which uses a cost/benefit approach. Development theory has evolved since the early 1950's (Streeten, P., 1971, pp.252-279) and has been developed by Dunning, Streeten, Behrman, Vaitsos and others. At the outset it emphasised foreign capital investment as the main factor in development, (Ibid) and looked especially at the MNE as a source of foreign investment in relation to both the home country's government and the host government.

Bahrman argued that many activities of MNE's brought with them relatively little capital or foreign exchange, but many other things instead (Behrman, J., 1960 and 1969). Later, many writers emphasised employment (investment in
human capital), management, entrepreneurship, technology and science, and research and development.

Development is concerned not only with economic, but also with social, cultural and political factors, which interact to achieve the objectives of both MNEs and host countries. The relationship between MNE objectives and those of the host country depend on the ability of both sides to pursue cost-benefit analysis.

1.3 Multinational Enterprises and Developing Countries

1.3.1 The Flow of MNE's in Developing Countries

According to a U.N. report in 1983, the total flow of foreign direct investment to developing countries increased from an annual average of $3.76 billion in 1970-72 to $11.76 billion in 1979-81 (U.N. 1983, p. 25). The United States was the largest exporter with 50 per cent of the total flow throughout the 1970's. The second ranking was the U.K. with approximately 14.5 per cent and Japan was the third with roughly 9 per cent of all MNE investment in developing countries. France and Germany also became important sources during this period, with France being responsible for 5.8 per cent during the period 1979-81 compared with 4 per cent in 1970-72. However, foreign direct investment in developing countries grew less rapidly than the GNP of these countries and considerably more slowly than their total domestic investment.
The bulk of foreign direct investment is directed to those developing countries which have natural resources and access to international markets for goods, services, and factories. On average, during 1979-81, 65 per cent of foreign direct investment flowed from developed countries to higher income developing countries, with an annual per capita GNP of over $1000. In contrast, developing countries with low incomes received less than 5 per cent of the flow during this period compared with 14 per cent in 1970-1972. Latin American countries are by far the largest recipient among developing countries, accounting for roughly 45 per cent of foreign investment, most of it from the US. Foreign investment in the Middle East at the same time accounted for only 5.6 per cent of the total.

As for MNE activities, Stopford and Dunning have classified MNE activity in developing countries into two categories, (Stopford, M., & Dunning, J., 1984) namely import substitution, designed to produce goods or services for the market in which the subsidiary operates, and export-orientation, relating to primary product activities (e.g. mining, raw materials and food production) or to rationalised product and process activities. Similarly, Reuber, et al (1973, ch.4) classified direct foreign investment in developing countries into market-oriented, export-oriented and government-initiated investments.

The above arguments illustrate the significance of MNEs as a vehicle for economic growth and development of host developing countries. The next section will attempt to
answer two questions: What is impact of MNEs upon the development of host developing countries? and Why should host government control be exercised?

1.3.2 Impact of MNEs and the Need For Host Government Control

As seen above, MNEs can have considerable economic impact on host countries. The economic impact is the main subject of controversy and debate, because the social, cultural and political impacts are usually less clear. In connection with economic impact, MNEs are frequently criticised for limited flow of capital, inadequate technology, limited job opportunities, adverse balance of payments, etc.

This section deals with this debate, exploring why the question of controlling MNE is an important issue in developing countries, and for what purposes control should be exercised. In considering the debate over the impact of MNEs upon economic development, four aspects will be examined: flow of capital, employment, effect on the balance of payments and technological impact. Transfer pricing will also be considered, to indicate the problems posed by MNEs for host developing countries.

1.3.2.1 Gross Investment Impact

Theoretically, MNEs are generally seen as a major source of funds to help the economic development of the host country. They supplement local savings and relieve foreign exchange shortages; they contribute to the achievement of
development plans; and they help to achieve priority goals for investment and speed up the rate of growth. However, critics of MNEs argue that their flow of foreign capital is very modest compared with domestic investment. The empirical evidence clearly supports this argument and shows that the total foreign capital contribution for foreign projects operating in Egypt during 1976-1987 accounted to merely 15% of total capital invested (see chapter 3). Also it was found that foreign subsidiaries tend to raise a large proportion of their capital requirements locally (see Squibb Egypt case study). A similar result has been obtained by Hood and Young, (1979, pp.39-40), who argued that only 10.5% of the total capital employed by U.S. foreign subsidiaries operating in host developing countries came from the United States, the rest coming from local funds, depreciation, and reinvested profits.

Foreign projects in developing countries are thus established with a minimal inflow of capital from their parent companies. This is because they seek to minimise the financial risk from currency variation and depreciation, and to reduce political risk in the event of nationalisation.

Therefore, the host government should have regard to these policies, which reduce the flow of foreign investment needed for economic development.

1.3.2.2 Employment Impact

Among the objectives of host governments in attracting foreign investment is employment creation. Also, MNEs
through their training activities are expected to increase the technical and managerial skills of local labour.

Considering the direct employment effects, the literature reveals two contradictory views (Kuwahara, Y., et al 1979, p.55).

On the one hand, it is argued that the flow of foreign investment positively contributes to employment by absorbing a large number of employees into work, paying higher wages, and providing better working conditions than local enterprises, as well as raising skills and training (Gladwin & Walter, 1980, p.510).

The above views are supported by several case studies. For example, it is concluded in the present study that the contribution of MNEs in Egypt for all employment categories is positive, but small compared with that of local enterprises (see chapter 3). Similarly, a study carried out by International Labour Organisation (ILO) in 1980 (quoted in Ghertman & Allen, 1985, p.66) estimated the amount of employment created by MNEs in developing countries at roughly four million persons in 1980 in all economic sectors.

The above estimate of employment created by MNEs in developing countries may appear small compared with the total manpower in those countries, which amounts to 840 million. However, if this number is compared with the unemployment in these countries, it may be argued that MNEs have made a contribution to employment, but it has not been significant.

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Apart from the direct employment impact, there is also the indirect impact which may emanate from the use of local suppliers, distribution channels, and ancillary services (Lall, S., 1979). This kind of impact is likely to be significant, particularly where investment is oriented to the local market. However, in reality, it is difficult to measure it, due to the inadequacy of statistics in this field and in those countries. According to Kuwahara, Y., et al (op.cit, p. 92):

"... to measure indirect employment effects, however, is even more difficult than to measure direct employment effects. Consequently, there is still little known about indirect employment effects. In the case of developing countries in particular, worthwhile data on indirect employment effects is virtually non-existent."

In addition to the above effects, training and skills are also considered a vital aspect of MNEs' contribution to host developing countries. In this respect, (Caves, R., 1982, p.266) stated that MNEs invest considerably in training in order to create the locally-qualified personnel at all levels which are necessary for economic development.

Opponents of this view contend that MNEs do not contribute to employment in developing countries (Kuwahara et al, 1979, p.55). This view stems from the consideration that the MNE only replaces local investment and displaces employment which already existed in local enterprises. In other words, their criticism rests on the view that MNEs
employ skilled staff who are already employed, rather than unskilled staff, and that additional investment simply results in a substitution of new employment for previous employment, at a marginally higher wage. Furthermore, contributions to such indirect benefits as training, and education programmes may be unclear and hard to measure. In addition they may cause "unfair" labour market competition and thereby impede the competitive position of domestic enterprises. Lastly, they may cause income distribution inequality.

The above views are supported by a survey carried out in some Asian developing countries (Indonesia, Thailand, Philippines and Singapore) (Ibid). The overall result of this study was that MNE operations can have a positive and/or negative impact on local employment in terms of number of jobs, wages and salaries, tax revenue, etc.

However, the above argument cannot be generally accepted. In developing countries, employment levels are generally well above marginal levels and widespread underemployment is common. In these circumstances the establishment of new investment seems more likely to result in the creation of new jobs than simply a substitution of new jobs for old (Rueber et al 1973, p. 167).

The flow of foreign investment in developing countries might therefore be expected to create new jobs for local workers and increase their skills in most activities, or to have an adverse impact on them. To measure this impact, it
is necessary to assess the MNE's contribution to local employment. This may be measured by the number of local jobs offered, the training programmes provided, and levels of wages and salaries paid, together with other circumstances which may arise as a result of the presence of the MNE, such as the level of technical skills, capital intensity, domestic wages structure, etc.

1.3.2.3 Balance of Payments Effects

The influence of MNEs on the balance of payments is seen by many host developing countries as very important. This is particularly true because their balance of payments position is often weak and MNEs are seen as a vehicle for relieving it. The impact occurs in three areas: capital, investment and trade. Several empirical studies have demonstrated that the presence of MNE's in a host country may cause a deterioration in its balance of payments, instead of relieving it. For example, if the earnings generated are repatriated and imported inputs increased, the net impact may well be negative.

In a survey by Lall and Streeten, (1977, pp.131-132) of 133 foreign enterprises in six host developing countries, it was found that the overall direct effects on the balance of payments were, with one exception, negative. The average effects for the countries in the sample, expressed as a percentage of sales for the total sample period, were 2.7 for Kenya, -25.5 for Jamaica, -11.7 for India, -55.0 for Iran, -35.3 for Colombia and -37.6 for Malaysia. Similar results were obtained in an empirical study conducted in
Egypt by the researcher, an exception being the import substitution effect which was slightly positive (see chapter 3).

On the other hand, some studies have suggested that the question that should be asked is, "What would have happened if MNEs had not operated in developing countries?"

The answer depends on whether the foreign subsidiary's output is additional to what would otherwise be produced or whether local substitution is assumed. In a survey by Falero, (1974, pp. 77-85), it was found that MNEs' impact on the balance of payments of host developing countries is mixed. MNEs have a positive effect on the balance of payments where they cause high exports earning and import substitution, while, in contrast, negative impact is caused by increases in dividends, royalties, fees for services, remittances of interest, capital repatriation and imported inputs. However, the balance of payments position is usually negative, because more money eventually goes out than came in. This is to be expected, given that MNEs would be expected to use either DCF analysis or payback, and will cause a continuing deficit in the balance of payments.

Dunning, (1981, p. 362) in his evaluation of the costs/benefits of MNE's to the host country has mentioned that the net balance of payments effects of MNE's activities are mostly negative as a result of the lack of effective government policies regarding export orientation, import substitution, foreign exchange control, and taxation.
There is no clear evidence to support the idea that MNEs assist host developing countries in enhancing their balance of payments situation. In some cases they have made a positive contribution, while in others, they have not. The probability of a negative impact exists, and host governments should exercise control measures, as suggested below, to avoid such a situation:

1) The host government should examine each foreign enterprise's books regarding transactions which involve foreign exchange in order to measure net foreign exchange earnings.

2) The host government should continuously monitor the proportion and the amount of profits and capital repatriated.

3) The host government should investigate the enterprise's books regarding income tax and other types of taxes.

4) The total value of the enterprise's product should be used as a base for measuring the export/import ratio. This requires that input-output tables should be available, showing both exports and imports in both quantity and prices.

5) Employment statements of both domestic and foreign wages and salaries must be reviewed, as well as the foreign currency transferred in terms of management fees and services.

6) Transfer pricing techniques which may be used for a
number of strategic reasons should be directly controlled by government policy.

The above steps cannot be taken effectively, without clear rights extended to the host authorities by a concession agreement drawn up between the host government and the MNE. To put control measures like these into practice, the host government needs to know why a negative balance of payment impact might occur. The literature on MNEs provides several reasons:

1. MNEs often seek to finance as much as possible of their assets and operations from local sources rather than the parent company and reinvested profits.
2. Foreign subsidiaries tend generally to import a high proportion of their input needs instead of utilising local resources.
3. Foreign subsidiaries are not willing to export their products and prefer to distribute them within the local market.

These aspects generally result in a negative impact on balance of payments of host developing countries (see Squibb case study).

1.3.2.4 Impact on Transfer of Technology

The transfer of eco-technical and managerial know-how plus the capital flow offered by the MNE is seen by many countries as beneficial for economic development. As far as the transfer of technology is concerned, two contradictory approaches can be debated.
On the one hand, several arguments against the potential benefits associated with technology transfers are found in the literature. For example, it is argued that (UN, 1973, p. 52, Hood, N., & Young, S., 1979, and Frank, I., 1980, pp. 150-151) technologies transferred by MNEs are much more concerned with capital intensity than creation of new job opportunities. Also, they produce products which are often too sophisticated, too highly designed, and too well - packaged to meet the needs of masses of low - income people. Instead they cater to the consumption demands of elites. Accordingly, it is suggested that host developing countries in which capital is very short but labour is plentiful should insist on production techniques that have been adapted to meet these conditions.

On the other hand, there is the argument put forward by Emmanuel, A. (1982), which favours the introduction of the most advanced technology. He argued that:

1. Capital-intensive technology makes available to the local market, the greatest quantity of products, thereby maximising social welfare.

2. The transfer of the most advanced technology helps to increase the development rate of most countries and hence lessens the gap in technology between the developed and developing countries.

3. MNEs, as the possessors of advanced technology, play a vital role in speeding up the acquisition of this technology by developing countries.

Furthermore, the role of the government cannot be
ignored, for the host government can play a crucial role in negotiating with incoming MNEs to obtain the type of technology which is appropriate to the local environment. It can also negotiate the price of this technology, for MNEs often insist on royalties to finance the R & D of future technology, and this is becoming increasingly costly for host countries. In the absence of government intervention, technology transferred by MNEs may lead to wrong investment priorities, inefficient allocation of resources and an adverse impact upon the balance of payments.

1.3.2.5 Transfer Pricing

Transfer pricing has been given great attention by MNEs and host governments. To the MNE, transfer pricing represents a means of shifting funds between group members through prices charged on transfer transactions (sales of goods, services, royalties, interest on loans etc.) which differ from arm's length prices. To the host government, it is presumed that the use of transfer pricing is against the national interest.

The literature on MNEs gives a number of reasons why the prices charged for MNE transactions differ from arm's length prices (Vaitsos, 1974, Lall, 1979 and 1980, Ghertman and Allen, 1985, Eiteman et al 1986, and Shapiro, A., 1986 pp. 318-326):

1. Minimisation of the overall tax burden charged against global operations. This can arise from selling goods and services at higher than arm's length prices to a subsidiary
located in a country with a high tax-rate and buying from that subsidiary at lower than arm's length prices.

2. Avoiding limits on profits remittance. This is often achieved through over-pricing imports to, and/or underpricing exports from, subsidiaries located in host countries which have strict exchange control regulations.

3. Avoiding price controls exercised by host countries. This is common where prices are fixed on the basis of cost plus a reasonable rate of profit. In such a case, the MNE may attempt to avoid the impact on its profitability by showing a high cost of production through transfer price manipulations (see Squibb Egypt case study).

4. Avoiding social and political pressures. In this case, the MNE attempts to use the transfer pricing technique to keep declared profits at a minimum. High profit rates may induce trade unions to ask for higher wages and may also induce government to ask for more revenue due to MNE's exploitation of national resources.

5. Avoiding the impact of local currency fluctuations caused by high inflation and by foreign exchange controls: profit remittance would normally have to wait until the end of the financial year, whereas the use of transfer pricing can generate a continuous flow of funds, so that profits are taken sooner rather than later.

6. Discouraging potential competitors. The MNE is able to enter the market to drive out its potential competitors. To this end, the MNE will be motivated to reduce its prices in the same market and show lower levels of profits in its
financial statements. This is often achieved by a transfer pricing strategy.

These practices are common, and the transfer prices charged to transactions between the group members of a MNE usually differ from arm's length prices. A survey conducted by Vaitsos, (1974) in Colombia found that overpricing in the pharmaceutical industry was 155%, in the rubber industry 40%, in the chemical industry 25.5%, and between 16-60% in the electrical industry. Similar studies have been made in other developing countries and provide further evidence of the use of transfer pricing manipulation by MNEs (see e.g. Lall, 1980, Rahman, 1982, Squibb Egypt, Part III).

These studies have also shown:
a) The apparent growth of intra-company transactions within MNE groups, in that more than 60% of the inputs of each subsidiary are supplied by the parent company or sister subsidiaries (see e.g. Squibb Egypt, part III and Rahman, 1982).
b) The prevalence of major inducements to transfer price manipulation in many developing countries (e.g. high tax rates, foreign exchange control, prices control, high inflation, and political risk).
c) The absence of effective techniques for controlling transfer pricing in these countries.
d) The difficulty of collecting the data necessary to check transfer price manipulations.

The above section provides clear evidence that MNEs in
developing countries tend to carry out policies that are primarily in their own interests at the expense of a negative impact on local economic development. In the light of this, an effective host government control system is essential to enhance the contribution of these enterprises to the national economy.

1.3.3 Host government control of MNEs : Literature Review

In the preceding section the groundwork was laid for a study of the control system required for host government control of MNEs. The main purpose of this section is to review the literature relevant to such control.

The literature distinguishes three main approaches: national control by an individual host government, regional control by a group of governments and international control by an international agency.

1.3.3.1 International Approach for Controlling MNEs

Since the beginning of the 1970s, international organisations, such as the UN, have endeavoured to establish codes for the regulation of the activities of MNEs, particularly in developing countries. The reason behind this, as Negandhi and Baliga, (1979, p.93) observed is that:

"These firms are supranational agencies and consequently beyond the reach of any nation-state. Accordingly, they should be controlled by international bodies, such as the United Nations"

Among the most active specialised bodies of the UN are the United Nations Conference on Trade and Development (UNCTAD), the United Nations Commission on Transnational Corporations (UNCTC), the United Nations Economic and Social
Council (ECOSOC), and the Ad Hoc Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting.

In 1972 UNCTAD adopted a resolution calling for the permanent sovereignty of nation-states over their national resources. This resolution reaffirmed the sovereign right of developing countries to nationalise any foreign property and establish controls over their national resources. The resolution also gives emphasis to the right of developing countries to expect that MNEs will respect and serve the sovereign interests of these countries and calls for greater international cooperation to this end. The resolution also called for studies on the development of the code and the establishment of an ad hoc intergovernmental working group of experts.

The task of UNCTAD is centred on the collection, analysis, and dissemination of information and drawing up international codes on restrictive business practices and transfer of technology (see UNCTAD, 1977, 1980 and 1981).

UNCTC was set up for the formulation of a comprehensive code of conduct on transnational corporations which is still under discussion (Grosse, R., 1982, pp. 414-433, Jenkins, 1985, pp. 18-19, Hewaidy, 1988, p. 50). The main purposes of the code are the harmonisation of regional investment policies and practices and the adaptation of the activities of MNEs' to the development and policy goals of their home- or host- countries. Furthermore, it can operate as a tool
for "public policy", or might fill gaps in domestic laws and practices and ensure a constant dialogue between states and MNEs (Ibid).

However, Negandhi & Baliga (1979, p. 96) and Hamilton, (1984) have pointed out that the control system adopted by international agencies is inappropriate for developing countries on the following grounds:

1. The formulation of an international code of conduct to regulate MNE activities must be evaluated on the basis of what such controls might accomplish for developing countries.

2. The task of international regulatory agencies is far from the interests of the developing countries.

3. International agencies lack the power to exercise control.

4. The economic situations and objectives of various countries are different; they thus require different types of economic control policies.

Furthermore, Sauvant (1977, p.394); and Jenkins (1985, pp. 18-19) noted the following difficulties:

1. What legal form should the code take? Should it be legally binding or simply voluntary?

2. To whom should the code be addressed? in particular should state-owned firms be included as well as MNEs?

3. How should any disputes be settled and on what terms should compensation be paid in the event of nationalisation of a MNE subsidiary?

4. What mechanisms should be created to ensure
implementation of and adherence to the code, and what sanctions for noncompliance can be applied?

5. Another cause of contention is that developed countries (the MNEs' home countries) insist that MNEs should be guaranteed equality of treatment with national firms; developing countries have considerable reservations about this.

The overall reaction to attempts to formulate an international code of conduct for multinational enterprises in developing countries has been negative, due mainly to the lack of an international agency with the power to exercise the necessary control, and to the differences in economic situations, national objectives and accounting systems of developing countries. In respect of economic situation and objectives, Gordon (1974, p. 83) argued that:

"with the diversity in HDCs' degrees of development, governmental sophistication, attitudes toward foreign investment and developmental priorities, it would be fanciful to expect any meaningful general code on treatment of MNEs to be agreed upon among HDCs as a whole or among any substantial number of them."

With regard to accounting standards and reporting, Briston (1984) pointed out that the international accounting standards and reporting devised by the UN, are not only worthless in the control of MNEs in developing countries but also are often positively harmful.

Finally, Negandhi & Bagila (1979, p. 96) asserted that talk of development and enforcement of a uniform control
system for MNEs is academic. A similar conclusion was drawn by Sauvant (1977, p. 396) who argued that any international effort aimed at regulating and controlling MNEs, whether issue-specific or general in nature, is difficult and time consuming to develop. He further emphasised that national legislation will remain the core of any effort to control MNEs.

1.3.3.2 Regional Approach for Controlling MNEs

One example of this approach is the Andean Pact (the Code of Investment and Decision 24 of 1977 and Decision 169 of 1982) adopted by the Andean group (Bolivia, Chile, Colombia, Ecuador, Peru, and Venezuela). The desire to establish a code of foreign investment on a regional basis stems basically from the view that no regulation by any single nation would serve to end restrictive practices by MNEs (Chance, 1978, pp. 1799-1809).

Although the regional approach has many advantages, its limitations are the same as those of the international approach. In this regard, Chance (1978) argued that:

"The limitation of this approach is that the larger and more diverse the grouping the more difficult it will be for the group to maintain unity."

He produced an example from the Andean group's experience.

"After the replacement of the Allende government in Chile in September 1973, the new Chilean government enacted a foreign investment law which was more receptive to foreign investment than the other members of the Andean Group considered compatible withDecision 24. The Group influenced
Chile to revise its new law, but the Group later gave permission for Chile to sell to foreign investors any of those companies that had been nationalised by the Allende government, despite the inconsistency of such sales with the provisions of Decision 24. Irrespective of the willingness of other members to compromise on particular issues, Chile has resigned from the Andean Group, apparently because its plans for encouragement of foreign investment are inconsistent with Decision 24."

A uniform international or regional system for controlling MNEs thus seems very limited and impractical, and the national approach seems to be the most appropriate form of control.

1.3.3.3 National Approach for Controlling MNEs

In general terms, control methods may be divided into those applied at entry and those applied after operations have commenced. Within each of these categories, there are legal, managerial, economic, financial, and political controls.

Several studies have focused on the issue of control as essential for achieving the host countries' interests. Most of these studies have been undertaken by those in the fields of economics, law, business, management, or politics. Little has been said about control of MNEs through the use of accounting reports by means of an appropriate supervisory network which would include the government auditor. This may be due to lack of knowledge of the accounting techniques used by host country institutions such as the government auditor, and lack of understanding of the foreign enterprise's accounting information system.
Behrman, (1972, pp.143-144) for example, suggested that the host country might control MNEs operating inside its boundaries by introducing legislation to compel MNEs to comply with its wishes.

Tindall (1975) reviewed ownership and control with reference to five of the world's largest enterprises and concluded that MNEs have outstripped national legal frameworks and that new legal frameworks are required.

However, Zouaoui (1979) and Senanayake (1982) argued that a degree of control will be exercised through exchange control legislation, tax law and regulation, and other national legislation, and that the laws of the host state may require a subsidiary to register as a corporation under host state laws and regulations.

Furthermore, as Vernon (1971, p.4) pointed out, because the economic role of MNE's in host economies is great, the attainment of local interests frequently necessitates interference in the operation of MNEs through the host's sovereignty over natural resources. The U.N (1973 & 1984) supported Vernon's approach, arguing that through international law, each nation has full and permanent sovereignty over its natural resources, a right which it should exercise in connection with MNEs' activities. The tea plantations and the tea manufacturing industry provide an example of such control (Tindall, 1975, p.XXXII).

Robinson (1976) examined in his survey of fifteen different countries, the entry control systems operated over
MNEs. His conclusion was that these systems represent national efforts to create a climate that both protects national interests and reduces risk by moving toward some degree of stabilisation of the relevant laws and regulations. In addition, the systems differ in both form and practice from one country to another. Some systems tend to be highly formal, with very little in the way of face-to-face negotiation. Others were much less formal.

Wallace (1980) distinguished three stages (entry, operation, and coerced disinvestment) of international control of MNE's activities.

He draws two main conclusions, the first concerning the nature of controls, and the second regarding their function. With regard to the nature of control, it is suggested that the role of international organisations in relation to the MNE's should be advisory, recommending domestic laws for application at the national level by each individual host government, which is in the best position to evaluate its own national requirements.

Wallace's second conclusion is that controls, as recommended by international "guidelines" and implemented by legislation of host governments, should be aimed at curbing the abuses not only of multinational enterprises per se, but also of national enterprises. By adopting these criteria, it is hoped that the major international bodies concerned with the issue of control would encourage the positive contribution which MNEs can make to economic and
social progress, while minimising difficulties which may arise from their operations.

Another approach to control techniques was adopted by Gladwin et al, (1980) who identified four types of control: entry, operation, financial, and terminal.

Different host countries appear to rely on particular control techniques. The Philippines, for example, seems to prefer entry controls, while India emphasises operating controls, with government interference in virtually all facets of day-to-day corporate activities. Terminal controls have been used by many countries including Sri Lanka, Chile, Venezuela, and Peru from time to time in specific sectors.

Dunning (1971, pp.34-36) stresses the role of policymakers in host countries, in understanding the effects of MNE’s behaviour on their countries. He proposed five steps to enable them to formulate a better policy for dealing with MNEs. These may be summarised as follows:

1. Recognition of a problem: organs of control have to know the potential effect of MNEs on the output of a particular industry, or the pattern of trade in the host country.

2. Identification of the character of the problem: it is necessary to evaluate the net benefits and costs that may stem from the activities of an MNE within the country concerned.

3. Study of MNE behaviour in relation to that of national firms.

4. Evaluation of the costs/benefits of alternative policies in order to assess the impact of MNE behaviour on other economic agents in the country involved.
5. Choice of a policy which is likely to contribute to the attainment of the objectives of the organ of control.

This appears to be an appropriate approach, as evidenced by the application of these proposals in Portugal, particularly in the context of its development planning, with favourable results (Dunning, J., 1981).

Hewaidy (1988) argued in his recent study of foreign manufacturing companies in Egypt, that control should be carried out through two integrated processes; namely entry and operation, in addition to ownership control to ensure that MNEs will benefit the national economy. The aim of his study was to

1. Identify the processes operated by the government to control foreign manufacturing companies at entry and during operation.
2. Identify the perceptions and attitudes of corporate executives toward the control process.
3. Test the perceived ability of forms of ownership of foreign investment to meet both national objectives and those of the foreign company.
4. Identify the likely effect of control measures on the flow of manufacturing investment into Egypt.

He drew three main conclusions, the first concerning the entry and operational control processes, the second relating to ownership policy and the last regarding control measures. With regard to the first, it was suggested that the control system as currently operated is inefficient and
should be improved to meet both national objectives and those of the foreign companies. As for the second, it was suggested that the existing ownership policy is sound and appropriate and should be continued. With regard to the third, it was recommended that control measures are unlikely to be decisive factors affecting the flow of foreign manufacturing investment into Egypt.

Nevertheless, his work might be criticised in four respects:

1. He focused totally upon the nature of control measurements rather than their effectiveness.

2. He concentrated only upon the processes of control applied under Law No. 43 of 1974, without any reference to other foreign investment laws such as Law No. 156 of 1953 and 159 of 1981.

3. He ignored the accounting and auditing techniques which should be applied at the entry (cost/benefit analysis) and operational (financial and administrative control mechanisms) levels.

4. The role of the governmental control structure, particularly the government auditor, was ignored.

The present study attempts to redress this balance by focusing on the use of accounting and auditing techniques as a control tool. An excellent starting point for this approach is Briston’s paper on "Accounting Standards and Host Country Control of Multinationals", (Briston, 1984) which suggested an appropriate framework for control.
This system has three fundamental steps. First, a concession agreement should be drawn between the host government and the MNE, showing in detail what benefits each side will provide for the other and what their respective obligations will be. The second point is that the agreement should be based on a feasibility study, compiled on a cost/benefit basis, which will reflect the objectives of both sides. The third stage involves financial and non-financial reporting and auditing, which must be based on a relevant accounting system in the country concerned, to ensure that both the MNE and the host government fulfil their obligations under the formal concession agreement. Several questions now arise: which accounting system will permit these reports to be prepared in the most efficient manner? What measurement criteria should be adopted for these reports and to whom should they be made available? What should be the role of the government auditor in the audit of these reports?

The United Nations (1979, 1984) in its guidelines for control of MNE activities has adopted a similar approach, but relies on accounting and auditing standards set by the International Accounting Standards Committee (IASC) which are inappropriate for the control of MNEs.

Briston (1978), Samuels and Oliga (1982) and Perera (1985 and 1989) have criticised the international accounting standards arguing that they are unable to fulfil the control function because they do not take into account each country's economic and environmental circumstances.
 Nonetheless, the enthusiasm of accountancy bodies from developing countries for joining the International Accounting Standards Committee suggests that these standards may influence the direction of accounting in those countries (Briston, 1984).

In fact, reliance on international accounting and auditing standards in developing countries may well impede the government control system, for these standards serve the goals and environment not of the respective countries, but of the MNEs. In this respect, Douban (1988) emphasised that the international accounting and reporting standards have been designed to serve the needs of the industrialised world, and may not be best for the needs of developing countries. Similarly, Zeff (1986) argued that:

"Each country's cultural, political, and economic setting is unique, and experiences from other countries can not be sensibly transported without being sensitive to environmental differences."

Samuels and Oliga (1982) also argue that:

"... Where economic, socio-political, cultural, and contextual differences between countries, nations, or societies exist, the problems of appropriate accounting standards will assume a different conceptual meaning as well as contextual significance .... in the case of developing countries where such differences tend to be not only highly pronounced, but also in a highly dynamic and fluid state, the relevance of international accounting standards becomes even more questionable."

Briston (1978) also stresses the weakness of international accounting and auditing standards as control tools for local government purposes, arguing that:

1. The information needs of a developing country are very
different from those of advanced countries like the U.K. and USA.

2. The adoption of international accounting and auditing standards entails a substantial investment in educational resources to train accountants in order to familiarise them with new standards.

3. This type of system is too much biased toward financial reporting in a capital market context and to the external audit of those reports.

As a consequence, each developing country must be encouraged not to standardise the structure and specifications of its information system for economic development, but to create a system appropriate to its own needs, based on the unique political, economic and social factors prevailing in the country.

It emerges from the above discussion in this section that a national control system which relies on the local accounting and auditing systems and the government auditor seems to be the most feasible form of control. Therefore, the study attempts to establish a comprehensive framework for the control of MNEs based upon close linkage with the government auditor and other supervising agencies, through an accounting reporting system, to achieve the country's economic and social requirements. This research examines the Egyptian experience in the light of the above approach.
Chapter II
Operational Framework of Host Government Control
Over Multinational Enterprises in
Developing Countries

2.1 INTRODUCTION

The main purpose of this chapter is to describe fully the proposed operational framework by which host governments could control MNE activities inside their countries, before attempting its application in Squibb Egypt as a case study. This chapter contains five major sections:

(1) Selection of the operational framework of control;
(2) Criteria of control;
(3) Structure of governmental control;
(4) Entry control;
(5) Operations control;
(6) Performance Evaluation.

2.2 Selection of The Operational Framework of Control

The previous chapter has highlighted the need for effective host government control of MNE's to make them more beneficial for the host national economy. This would be based on an integration of local accounting, and reporting systems, and an appropriate organisation of control such as the government auditor.

Before describing the proposed operational framework, the next sub-section is primarily concerned with what is meant by a control system.

2.2.1 Accounting Control in General

Studies by Tocher (1970, pp.159-180), Flamholtz et al
(1985, pp. 35-50), and Emmanuel & Otley, (1985) have shown that the objectives of an organisation's management have little chance of being achieved unless there is an effective control system. Otley & Berry (1980, 231-244) emphasised that organisation without some form of control is impossible.

Anthony & Dearden (1976, p.3) observed that a control system aims at achieving desired goals and objectives. Flamholtz et al (1985) also point out that control systems are techniques and processes to achieve the goals of an organisation, and that this control system is subject to three different approaches: sociological, administrative and psychological. According to the first, control is accomplished through structural mechanisms of rules, policies, hierarchy of authority. Under the second, the control mechanisms are plans, measurement, supervision, evaluation and feedback. Lastly, the psychological approach tends to rely on the mechanisms of goal and standard setting, extrinsic or intrinsic rewards, and feedback. These approaches can be exercised either internally (by the organisation's management) or by an external agency (government authorities) (Tocher, 1970). In designing the operational framework of control in the present study, the focus will be only on the first two approaches, and on control exercised by an external agency.

Adopting a similar view to the above authors, Copeland & Dascher (1978, P.337), and Lucey, (1983, p.133-134) asserted that the control process is the comparison of
actual performance against a plan or target. Such comparison reveals variances which can be used either to guide activities back toward the original plan or to revise the original plan.

The control system can thus be viewed as the process by which the actual performance and that planned are measured and compared, and necessary corrective action undertaken. To this end, Otley & Berry (1980) specified at least four necessary conditions which must be met before any process of control is applied. Firstly, objectives for the control systems must exist, for without an aim or purpose, control has no meaning. Secondly, criteria for measuring results must be defined relative to the objectives. Thirdly, a predictive model of the system is needed so that causes for the non-attainment of objectives can be determined and corrective action proposed. Finally, there must be a capability of taking action so that deviations of attainment from objectives can be corrected.

Their control system contains the following elements:
1. Objectives or criteria specifying expected performance.
3. Comparison of actual and expected performance.
4. Evaluation of variances.
5. Feedback.
6. Corrective action.

Anthony & Dearden (1976, p.102), produced a general accounting control model including these elements, as shown
in Figure (2.1).

Their model starts with the setting up of goals and strategies according to which plans are prepared specifying the expected performance. In the operating stage, the actual performance is measured and periodically compared with the expected performance. Based on this comparison, and on other relevant information, the management judges whether or not the performance was satisfactory. This gives rise to

![Figure 2.1: The Control process](image)

different types of feedback. If the performance was satisfactory, this is communicated to the executive manager with an appropriate commendation. On the other hand, if the performance was not satisfactory, (a) the manager may be motivated to take corrective action; and/or (b) the plans may be revised.

The control process thus recurs in a regular cycle, and its elements constitute a closed loop. This means that the control model is a closed cycle, with one element leading to the next.

In the light of the above general accounting and management control model, the following section discusses the operational control framework which host governments should adopt to control MNEs. The model will be used to evaluate the current control system operated by the Egyptian government, taking Squibb Egypt as a case study to find out how this system may need to be revised.

2.2.2 Host Government Control Model In Operation

It is now possible to draw up a theoretical model for host governmental control of MNE's in developing countries. When MNEs invest in the host country, two integrated control stages should be applied, namely entry and operating controls. In addition to this, the effects of MNEs activities should be evaluated by such criteria. If these steps are not taken, the host country's benefits from MNEs may be reduced (UNCTC, 1985, p.8).

The host government control framework is therefore essential for maximising the host country's benefits from
MNE operations. Figure 2.2 indicates in a simple manner the elements of the control mechanism that are relevant to this study.

1. The National plan which includes goal-setting for both the host country and foreign enterprises.

2. Criteria specifying expected performance and measurements of actual performance. These include value added, employment, balance of payments effects, accounting rate of return and net present value.

3. The government control structure which comprises the bodies (government auditor and relevant ministries) which are in charge of the control process.

4. The entry control system, which refers to the process by which the host government examines a particular proposal (feasibility study) of a MNE in order to determine whether it should be accepted or rejected.

5. The operational control system, which refers to the process of monitoring the actual performance of a MNE through accounting techniques.

6. The performance evaluation system, which refers to the process of measuring the real influence of MNE on the national economy.

7. The feedback element, which refers to the delivery of information regarding the actual performance compared with proposed objectives, which would be submitted to the responsible bodies for corrective action.
Figure 2.2
A Framework for Control of MNEs by Host Government

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Feedback

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Organs of Control

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Concerned

Feedback

Audit

Government Auditor

Operations

Feedback

Outcomes

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Accordingly, the government control process starts with a concession agreement drawn up between the host country and the MNE which generates a list of objectives for each side. The host government then delegates the relevant ministers and its government auditor to investigate the proposed project at the entry stage, based on a feasibility study designed on a cost-benefit basis, reflecting the objectives for each side. The appraisal of the project will also rely upon the host country’s economic policies, and the legislation established for this purpose.

At the operating stage, the project’s results will be measured using economic and financial criteria which will require an appropriate accounting information system. Variances are fed back through the reporting system via the operational control structure for corrective action.

2.2.2.1 Criteria of Control

The main purpose of adopting such criteria is to provide the host government officials who are in charge of controlling MNE’s activities with measurement rules for deciding whether or not these enterprises are beneficial to the national economy. Thus this section deals with two main sets of criteria: economic and financial criteria. The economic criteria centre on local value-added, employment, and balance of payments. The financial criteria are concerned with accounting rate of return and net present value.
2.2.2.1.1 Economic Criteria

As mentioned above, the expected economic contribution of a MNE will be measured by local value added, employment and balance of payment effects. This section outlines these measures as follows:

2.2.2.1.1.1 Local Value Added

Dunning (1981, p.365) has defined the local value added as the potential or actual economic value derived from MNEs' activities to the host economy as a result of their presence within that country. His local value added calculation is as follows:

Gross Output (Quantity of Goods Sold x Prices)

\[ \text{Gross Local Value Added} = \text{Gross Output} - \text{All imports} \]

\[ \text{Net Local Value Added} = \text{Gross Local Value Added} - \text{Depreciation} - \text{Payments to foreigners} \]

The statement of gross value added thus comprises the value of a foreign enterprise's production at selling price less all imports required. Net value added is obtained by subtracting depreciation and payments made to foreigners (e.g. dividends, royalties, management fees, etc.) from the gross local value added. In addition, the technology that might be acquired and R & D are necessary factors to be evaluated in the same way as the rest of the social
cost/benefit analysis, and included as part of the output and input of a particular foreign project (Lal, 1975, pp. 66-69). This will give a full picture of the "local wealth creation" of the project.

To calculate the gross local value added from the host government's point of view, price mechanisms should be adjusted so as to measure the correct social and private profitability for both the host government and the MNE (Ibid.). This will be done by adjusting the actual market price to the accounting price of all inputs and outputs, including the shadow price of labour. Adjustments of this sort will generally reduce the distortions which make a socially desirable project unprofitable. In this respect, it has been argued that in many developing countries, market imperfections and sub-optimal governmental control means that actual market prices often do not correctly measure the social costs and benefits of producing the relevant inputs and outputs of an investment project (Lal, P., et al 1975, p.43). Little and Mirrless (1974, pp.119-126) explained that the domestic prices which the MNE faces and sometimes influences, may not accurately reflect the social value of the resources used, either because of market distortions (tariffs, subsidies, inappropriate exchange rates) or because of implicit or explicit price control (e.g. the labour market may exceed the opportunity cost of employment).

To avoid such distortion, the calculation of the cost and benefits of MNE's should be based on accounting prices in terms of the international market, which will be imputed
to domestic inputs and outputs to reflect the social cost of resources deployed (Ibid).

Local value added of this sort is a convenient yardstick to measure the economic profitability of a MNE to host economy in the short term, but in the long term, it may be a weak measure as a result of changes in levels and prices of inputs and outputs, productivity and investment methods. Therefore, in the long term, economic development is usually viewed in terms of increase of output per capita. This in turn depends on the quality and productivity of material and human resources and the amount required to be invested to make resources more productive.

2.2.2.1.1.2 Employment

Among the objectives of host government economic policies to attract foreign investment is that of creating employment and improving skills. Therefore, the host government requires first that in order for a project to be approved it should provide employment to at least the level specified in its investment code and should train the employees to acquire new skills. In the operating stage, it is necessary to assess the MNE’s contribution to local employment. This may be measured by the number of local jobs annually offered, the training programmes provided, and levels of wages and salaries.

In addition, comparison between these enterprises and local enterprises will be made in terms of the factors outlined above. A comparison between employment levels in
foreign and local enterprises would be useful in revealing the direct incentives which attract the labour force to MNE's such as wages and other earnings, conditions of work, fringe benefits, welfare facilities, occupational health and safety, and working hours.

2.2.2.1.3 Balance of Payments Effects

In order to measure the potential and actual effects of a foreign enterprise on the host country's balance of payments, the model adopted by Lall & Streeten (1977, pp.131-132) will be used, whereby the direct effect of the balance of payments is calculated as follows:

\[ B_d = (X + I) - (C_k + C_r + R + D) \]

Where:
\[ B_d = \text{The "direct" balance of payments effects of an enterprise;} \]
\[ X = \text{f.o.b. value of exports;} \]
\[ I = \text{inflows of equity capital and loans from abroad, including earnings retained out of profits, net of capital and loans repatriated;} \]
\[ C_k = \text{c.i.f. value of capital goods imported;} \]
\[ C_r = \text{c.i.f. value of raw materials and intermediate goods imported (excluding finished goods imported for resale);} \]
\[ R = \text{royalties and technical fees paid abroad after tax;} \]
\[ D = \text{net after-tax profits and interest accruing abroad, and including retained earning.} \]

2.2.2.2 Financial Criteria

Without a clear measure of the project's financial performance, there is no real assessment of its profitability. To evaluate a project's profitability, this study will focus on two financial measures, accounting rate of return and net present value.

2.2.2.2.1 The Accounting Rate of Return (ARR)

There is considerable agreement among economists that
accounting rate of return is an inadequate criterion for foreign project selection or for assessment of its financial performance. Most criticism has centred on the following points:

1. It is difficult to use the accounting rate of return unless prices, depreciation policies, inventory policies, and the income stream are extremely stable.

2. The accounting book value of assets and their economic value may often vary, which will distort accounting ratios.

3. Lack of accounting data for measuring project profitability.

Dunning (1966, pp. 5-15) criticised the accounting rate of return as an assessment criterion of US. foreign enterprises in the U.K. on the grounds of the inability of accounting procedures accurately to reflect net income from a foreign enterprise’s accounts, particularly in times of obinflation. In addition, foreign enterprises may often use transfer pricing, which consequently distorts the profit ratios for performance evaluation.

It has been argued that, instead of the accounting rate of return, internal rate of return incorporated with net present value provides a better criterion for measuring project profitability.

However, despite the limitations of the ARR, the technique is still widely used by accountants to measure the profitability and analyse the performance of a company or an industry. This is based on the premise that ARR is a correct measure of profitability except during periods of rapid
changes in prices and ties in directly with the accounting process.

2.2.2.2 Net Present Value

It has been suggested that the net present value criterion is one of the best financial criteria to be used to select new foreign investment projects. It is achieved by discounting the difference between social benefits and costs of each year back to the present year. The discount rate used is shadow rate*, not the current rate of interest. The Net Social Benefit (NSB) from the operations of MNEs in any year is given by MacDougall (1960, pp.13-35) and Lal (1975, pp.84-86) as follows:

\[
NSB_n = \left( P_{xfn} - P_{xdn} \right) X_n + a_{in} \cdot \left( P_{idn} - P_{ifn} \right)
\]

\[
+ h_{jn} \cdot \left( W_{jn} - W_{sijn} \right) + E_n + K_n + P_n + T_n
\]

\[
- \delta_n - \nu_n \quad (5.1)
\]

Where:

- \( P_f \) is the border price of the output (x) and the inputs (i)
- \( P_d \) is the domestic price of the output (x) and the inputs (i)
- \( X \) is the output
- \( a_i \) is the input of the i'th good, which includes costs of plant and machinery
- \( h_j \) is the input of the j'th type of labour
- \( W_d \) is the shadow wage of the relevant type of labour
- \( W \) is the actual wage of the relevant type of labour

* Shadow rate is defined as the weighted average cost of capital that would be produced elsewhere in the economy (Wells, 1975). In other words, it is the social rate of return on the capital that could be allocated elsewhere in the economy, which is also the discount rate to be used for discounting the stream of benefits and costs to be obtain the net present value of the proposed foreign project (Lal, 1975, pp. 82-83).
& - are the dividends and capital repatriated in foreign exchange
v - is the foreign exchange value of the retained earnings of the foreign investment
E - represents the net external effects of the project
K - the capital inflow, inclusive of retained earnings
p - is the return (profit) to domestic capitalists (if MNE is a joint venture (if the MNE is 100% foreign-owned, this term is = 0)
T - is the sum of all the direct taxes levied on the foreigner.

The last four terms are self-explanatory, and provide the direct benefits to the host country from foreign enterprises, namely, through the taxes levied on MNE's in that country (T), the net inflow of capital (K), the return on any domestic capital that may be associated with the MNE (p), and the net external effects of the MNE (E). The W's is also traditionally associated with the benefits to the host country as has been seen earlier. Having obtained the NSB, as given by the above formulation, the net present value is then as follows:

T \begin{align*}
\text{NSB}_n &= 0 \\
n=0 & \left(1 + \text{IRR}\right)^n
\end{align*}

This criterion can be used as a guide for accepting or rejecting a particular foreign investment project. If a foreign project has a positive social value from the host government's point of view, it is acceptable; if not, it should be rejected.

In brief, the selection and evaluation of a foreign project from the host government's point of view should
largely rely on a comparison between its costs and benefits at the same point of time, namely the time of the project selection decision and that of performance evaluation at the operating stage.

2.2.3 The Structure of Government Control

The purpose of this section is to deal with the structure of host government control required for controlling MNEs activities at both entry and operating stages.

2.2.3.1 The Role of the Relevant Ministries

The foreign investment agreement often specifies the legal framework of the relationship between host government and MNEs, and the rights and obligations of each party. Based on this agreement a legal structure of governmental control may be created.

The host government should set up a division in each ministry concerned, with the function of investigating and following up foreign investment within their sectors. These divisions would liaise closely with central government in the choice of objectives and coordinating the foreign investment policy.

Once the feasibility study is received, the first task of these divisions is to appraise it. Three broad issues should be considered:

1. Is the project consistent with plans for the development of the particular sector?
2. Is the project consistent with the laws and regulations
specific to the sector?

3. Do the technical data submitted by the proposed project appear reasonable in the light of the information available as to costs and market conditions?

In addition, the division will complete an economic analysis in order to find out how much output will be produced, its selling price locally compared with prices on the international markets, the numbers to be employed, the training to be provided, the expected value added of the project, etc.

The second task of the division is to report its recommendation to the central government authority, indicating any weaknesses in the project.

At the operating stage, the essence of the control function will be the follow-up of the project's feasibility study, and the comparison of actual and proposed performance in terms of the objectives previously formulated. Of course, if it is found that inputs will be significantly greater or outputs less than were previously predicted, an amended feasibility report should be submitted.

This work requires that the relevant division of the ministry concerned should have a staff trained in methods of control and performance evaluation. This could be achieved by issuing a guideline manual and by arranging training programmes.
2.2.3.2 The Government Auditor as an Organ of Control

The reports prepared by the external auditor appointed by the parent company are based on published accounts and are inadequate for host government control purposes. This is partly because the auditor is not an agent of the host government and is not appointed to evaluate management operations, and partly because his duty is merely to certify that the enterprise's books fairly reflect its position; he is not concerned with the enterprise's policies or its economic performance.

To remedy this, economic, financial and efficiency reports on foreign enterprises for host government purposes must be prepared by a government agency, probably the state auditor.

The main responsibilities of the government auditor as discussed by Lane (1981, pp.44-46) are:

1. to carry out preliminary appraisal and analytic review of projects feasibility studies;
2. to investigate and check budgets and follow up their actual performance;
3. to compare the actual with the proposed performance;
4. to carry out both financial and efficiency and effectiveness audit so as to prepare auditing reports and submit them to central government.

Traditionally, the major aim of government audit departments has been to ensure the accuracy, completeness and legality of the accounts of public and private enterprises, particularly those funded by the state budget.
However, there has been in recent years an extension of this role beyond financial and regularity audit, to include efficiency and effectiveness audit. This will involve performance evaluation of both public and private enterprises, including foreign enterprises where the host government is involved in their surveillance, or owns part of their capital.

The new responsibilities of the government auditor regarding MNE's involve three types of audit: post-audit of the feasibility study or planning stage, financial and compliance audit of enterprise's accounts, and the efficiency and effectiveness audit of the enterprise's activities. Dahmash, (1982, pp. 89-114) has produced a model to demonstrate the government auditor's role in the operating stage.

First the government auditor performs the financial and compliance audit to verify that the enterprise's transactions, records and reports are compiled in accordance with government laws. Then, performance auditing will be carried out to measure the enterprise's efficiency in utilising its available resources. Finally, effectiveness audit will be undertaken to measure the extent to which government objectives are achieved.

In order to fulfil the above responsibilities, many steps must be taken. Briston (1984) claimed that government audit staff need to be retrained and the size of its department also should be increased, to include a wider
range of disciplines, such as law, engineering, operational research, surveying, etc. However, Staats (1979, pp.1-10) pointed out that the training of government auditors and their staff is often neglected in developing countries.

2.2.4 Entry Control System

The main purpose of any control system is to ensure that only those foreign projects which will benefit the national economy are accepted. This section discusses three major aspects of the host government entry control process: entry requirements, appraisal of the project based on cost/benefit analysis, and the concession agreement.

2.2.4.1 Entry Requirements

Many host governments set conditions upon MNEs at the point of entry in order to ensure that their operations are consistent with national economic policies. Conditions that may be imposed differ from country to country, depending on the country's bargaining power vis-a-vis MNEs, the level of its economic development etc. In general, they may contain the following (Stover, 1982):

1. Reservation of strategic sectors for local enterprises.
2. Requiring that MNEs must participate with local enterprises in certain sectors. Lecraw (1984, pp.27-43) stated that host countries insist on local participation because they would like access to more information about payments for technology and management, pricing of inputs and outputs and intercompany trade, and the amounts of profit reinvested and remitted abroad.
3. Requiring that a specified proportion of key positions in executive ranks and on the board of directors should be manned by nationals.

4. Requiring that the domestic market should be opened for both local and foreign enterprises. In practice, each country attempts to create an instrument of antitrust policy giving power to government officials to prevent market distortion as MNE's attempt to dominate the market (Caves, 1982).

5. Requiring that each foreign enterprise should keep a special account to record its foreign exchange inflow and outflow in order to gather information which helps to control profit remittance and capital repatriation.

6. Requiring that MNEs should engage in intensive training programmes.

7. Requiring that MNEs raise more of their debt financing outside local capital markets and use the local market to raise equity capital.

2.2.4.2 The Appraisal of a MNE Proposal

Foreign project appraisal in a host country should rest, to a large extent, on the use of cost/benefit analysis.

The function of this technique is to determine whether or not a particular project is financially, economically and socially beneficial for the country. Belkaoui, A. (1985, p. 337) argues that the function of cost/benefit analysis is to enumerate all socially relevant costs and benefits of each proposed project for the purpose of defining and
selecting those projects which maximise the present value of all benefits, less costs, subject to specified constraints and given specified objectives.

Hence, for any foreign project proposal to be acceptable, the present value of benefits should exceed the present value of costs. To achieve this, Gambling (1974, p.164) suggested a checklist of questions to be answered:

1. What are the objectives and constraints to be considered?
2. Which costs and which benefits are to be included?
3. How are the costs and benefits to be valued?
4. At which interest rate are they to be discounted?
5. What are the investment criteria to be used?

To answer these questions, Wells (1975) has argued that the process of analysis of a foreign project's costs in relation to benefits within the host country includes technical, financial and economic aspects that are different from those the foreign investor himself studies when he considers a potential project. Moreover, he stated that all relevant social costs and benefits of the project should be measured by shadow prices rather than market prices, in order to determine its contribution to a country's socio-economic development objectives. The common criterion of evaluation used here is the social net present value, using a shadow discount rate instead of the current rate of interest to discount back the excess of return over the costs of each year to the present year.

If the proposal is satisfactory, approval is given, and
an entry agreement is drawn up between the host government and the MNE. If the proposal is unsatisfactory, a negotiation process takes place with the purpose of modifying the proposal to better meet national objectives. These processes will be separately reviewed in detail below.

2.2.4.2.1 Technical Analysis

When the proposal is received, the government authority will send a copy of the feasibility study to the organisation or ministry in whose sector it belongs.

Here, as explained in section 2.2.3.1 the feasibility study will be examined by a technical group with specialised knowledge of the sector concerned. At the same time, the financial and economic aspects of the project will be investigated.

2.2.4.2.2 Financial Analysis

The financial examination is the second step in the project appraisal. This analysis begins with a review of the estimated financial statements. The host government auditor then undertakes a detailed examination of the statements for each period individually. During the construction period, the investigators will examine the establishment costs including the cost of fixed assets, the sources of finance, the currencies used, the cost of land, the cost of goods and services required, the cost of other capital investment to be made during the period concerned, working capital, operating costs, etc.

Next, the resources which it is anticipated will be
available during the construction period will be checked as follows:

1. The income statement will determine the funds which can be supplied from sales and other revenues.

2. The cash flow statement which includes an estimate of receipts and expenditures, will be examined in order to determine whether funds will be available when needed.

3. The balance sheet will indicate the financial position of the proposed project during the construction period.

Normally, these resources comprise funds generated from operations and long or short-term borrowings.

The same procedures and principles of investigation which were applied to the construction period are carried on into the operating period to show the likely financial results for the host country of the project's operation. Therefore, an examination will be made, for example, of whether the revenues expected during the operating period represent a reasonable return on the capital investment, in terms of the payment of tax and domestic dividends etc., whether there is an adequate margin in the funds generated by operations to meet fixed financial obligations, and whether revenues will be adequate to establish reserves needed for further expansion. In addition, an investigation will be made as to whether the expected operating expenses include payments outside the country such as dividends, interest, royalties, and fees, whether there are sound depreciation policies to deal with assets, and so on. The
investigation will also include the sources of finance, the currencies used in finance, interest and repayment of borrowed capital, anticipated rate of return, distribution of profits, amount of exports, expected domestic sales, and the likelihood of transfer pricing techniques being used.

Despite the importance of the financial analysis, it cannot reflect all aspects of the project analysis by indicating its net social benefits to the country. Therefore, it is necessary to consider other factors in the feasibility study. These include economic aspects and external effects. These aspects are based on the net social present value which is the most appropriate method for the host government to use in assessing the foreign project’s costs and benefits.

2.2.4.2.3 Economic Analysis

The economic analysis begins with several basic questions, such as: Is the sector of the economy into which the project falls one which deserves priority? Will the project contribute effectively to national production, output, employment, and the balance of payments? The project will thus be examined in terms of:

1. its role in the socio-economic development plans of the country;
2. its impact on the scarce resources available in the country;
3. the type and size of product to be produced, and its selling price locally compared with its selling price on the international markets;
4. the number of local workers to be employed, their wages, and the type of training to be provided;
5. the expected local value added to be provided;
6. the expected effects on the balance of payments in relation to the following:
   a. Is the project export-oriented or does it offer import-substitution?
   b. How much of its production is to be exported and what proportion of its requirements is to be imported?
   c. How much foreign currency is to be transferred in the form of dividends, interests, fees, royalties, and repayment of loans?
   d. What will be the net impact of the project on foreign currency?

In the light of the above, the investigators will measure the costs and benefits of each factor based on market and social (shadow) prices, in order to reflect the real net economic benefits to the economy and the society as whole. This requires that inputs, outputs, and external factors should be specified both by quantity and value. The investigators thus evaluate the streams of costs and benefits for the life-cycle of the project, starting from the construction period, and then discount them for future years to yield a social net present value of the project. In addition to these steps, a technical analysis is made in order to assess the technology to be used by the potential
project.

2.2.4.3 The Concession Agreement

Once the host government has accepted an MNE's proposal, a concession agreement, based on a feasibility study, must be drawn up between them, in the form of a legal contract signed by the parties. The main purpose of this agreement is to specify clearly what benefits each party will provide for the other, protect their legitimate interests and clarify their respective obligations. Accordingly, each party should attempt to identify its objectives as clearly as possible.

The host state desires MNEs to contribute to the economic development of the country. The pattern of this development, as previously explained, is usually defined in a plan which is based on a selective investment policy, and which determines the obligations imposed upon the MNE by the state, to integrate its operations into the national economic plan. The possible objectives that a host country might seek to meet from MNEs are: economic growth; creation of jobs; an enhanced balance of payments position; enhanced government revenues; enhanced local participation; obtaining new technology and production techniques, and stimulating local competition. Certain other important factors should also be considered by the government when specifying its objectives. These include protection of national sovereignty, the extent of exploitation of natural resources, employees' rights and training, compensation, law and regulations, the accounting system, reporting system and
auditing, and State control techniques.

From the MNEs' perspective, specific conditions should be fixed in the agreement to ensure a fair return. Other issues to be considered may include protection of property against the possibility of expropriation or nationalisation without compensation, local equity participation, free transferability of capital and earnings, customs and taxes exemptions, restriction on transfer technology, disclosure of information, incentives, competition, and market structure.

Both sides will wish to see appropriate provision for arbitration in the event of any dispute, and to be assured that redress will be obtainable, should there be a breach of the agreement by either party.

When the objectives of both parties have been specified and the MNE begins operating, the host government's control system comes into operation, in accordance with the agreement. The host government will need access to accounting records of the MNEs transactions, particularly with the parent company, in order to verify transfer prices, technical and management charges, etc.

Any dispute arising between the two parties with respect to the interpretation, application or execution of the agreement, will be referred to the jurisdiction of the country concerned. However, in order to ensure that the host government is bound by its obligations under the concession agreement, international arbitration should be available for final settlement. Any dispute arising between the two
parties should be submitted to an independent international arbitration agency such as the International Centre for Settlement of Investment Dispute (ICSID), and the arbitrator's decision should be accepted by both parties.

Within a concession agreement framework such as that outlined above, host government control at the operating stage would be rendered extremely effective, whereas without a clear identification of objectives by the host government and access to the accounting records of the MNE, control has no meaning.

To sum up, the draft of a concession agreement first defines the objectives of the contract, the duration of the agreement, its stability, states the nationality of the legal person and other such details, and determines the law applicable to the contract. In addition, it indicates the obligations of the host state and the MNE with regard to the execution of the investment. The draft also determines the relationship between the MNE and the State regarding government control, taxes and customs, transfer of funds, and settlement of disputes.

2.2.5 Operational Control Systems

The operations of a MNE are subject to the requirements and objectives imposed at entry. Therefore, the host government should make sure that the enterprise is operated according to the objectives agreed in its feasibility study. This is the function of the operational control system. This section deals with three major aspects of that control
system: financial control, administrative control and performance evaluation.

2.2.5.1 Financial Control System

The financial control system may be classified into two integrated control processes: monitoring the actual performance by using a particular reporting system and measuring the actual performance against the expected performance.

With regard to the first element of financial control, many studies have asserted that it should centre on remittances of earnings, profit for income tax purposes, currency translation, and transfer pricing policies (Gladwin et al 1980, Berenbeim, 1981, and Thorelli, 1983).

The government auditor will carry out this task, by means of financial audit and effectiveness audit. Financial audit is intended to provide an impartial opinion on the subsidiary's financial statements and records. The effectiveness audit examines the enterprise's operations to ensure that all activities are performed in an economically and financially satisfactory manner.

Thus, the actual audit starts with a thorough study of national legislation and regulation policies relating to the activity of foreign enterprises. This provides the auditor with a frame of reference. This is followed by a study of documents relevant to the activity being examined - plans, internal control system, accounting policies, financial reports and other relevant information.

It is then the government auditor's legal duty, subject
to the concession agreement, to give an opinion on the truth and fairness of the financial statements. Business transactions during the period under examination should be checked and verified based on the evaluation of the internal control systems. Purchases, sales, imports, exports and exchanges between the enterprise and other subsidiaries should be examined to ascertain that they are consistent with the entries recorded in the books. It should also be seen that prices, allowing for foreign exchange value, appear to be reasonable by reference to published sources.

It is further recommended that this review should cover aspects such as the acceptability, consistency and appropriateness of accounting policies adopted by the enterprise, the compatibility of its financial results, the adequacy of disclosure of these results, and the compliance of the financial statements with statutory and other requirements (Auditing Guidelines, 1980). In this way, the balance sheet elements must be verified by the government auditor to make sure that assets and liabilities are as claimed and that the values given to them are acceptable. This verification will help the auditor to judge the financial position of the enterprise. In addition, it will help to assess the accounting information contained in the profit and other related financial statements, for example, in relation to the existence and valuation of inventory, provision for doubtful debts, the depreciation of fixed assets and other considerations.
The procedures used in monitoring a foreign enterprise's financial statements are much the same as those used with domestic enterprises. However, there are many special problems, such as remittance of profits and funds, transfer pricing, and foreign exchange rates. These problems must be scrutinised by the government auditor and other interested parties.

For example, with regard to royalties and management fees, the host country normally allows these to be paid, as a legitimate business expense, on the basis of concession agreements. However, the payments that are allowed to a parent from subsidiaries must be tightly monitored by the government auditor, the finance ministry, the tax authority, and the central banks. The government auditor’s task is to achieve a fair balance between the services provided and the fees paid, firstly to ensure the continued implementation of these services by the parent company and secondly to prevent overstated payments, so that only reasonable royalties, fees and overheads are permitted.

Therefore, the government auditor should consider the following points:

1. The rate of royalties, fees and overheads must be carefully defined, specifying whether the payments are calculated as a percentage of the subsidiary’s sales price, net sales price, gross revenue, or assets.
2. The actual amount paid must be compared with the rate previously agreed.
3. The agreement must specify the date of payment.
4. The agreement must specify the currency in which the fees, royalties and overheads are to be paid, and the location at which payment is to be made.

The same considerations should be used with dividends and other payments and transfer pricing policies to ensure that the host country's objectives are fulfilled.

With regard to financial performance, the process starts with the periodic comparison of the actual results with the planned performance. In addition, financial ratios will be compared to ensure that the enterprise is performing satisfactorily.

If the financial operations are seen as satisfactory, then they are consistent with the feasibility study and have provided the agreed benefits. If the performance was unsatisfactory, two types of action might be undertaken: the enterprise might be asked to take corrective action and/or the two sides might renegotiate the agreement.

2.2.5.2 Administrative Control System

Administrative control is the second element of the operational control process. Berenbeim (1981) stressed that administrative control is exercised through interference by host government officials in the subsidiary's decisions. This interference takes two forms: active interference, and that exercised through the monitoring process. This section outlines the administrative control process which may include production control, import/export control and employment.
2.2.5.2.1 Production Control

The relevant division in the supervising ministry may require that the foreign subsidiary should achieve a certain level of production, and that raw materials should be purchased from local suppliers. In addition, the foreign subsidiary may be asked to sell or produce a certain product at a limited price into local markets, or to export a certain percentage of production, as a condition of entry. Moreover, it may be asked to disclose its production techniques, annual capacity utilisation, the level of technology used, physical output by lines, and new products and processes to be introduced. This information should be compared with the predetermined goals as set out in the feasibility study and/or the concession agreement.

The government auditor will also focus on how value added is calculated, the proportion of inputs of local origin, how much output was exported, how much was produced for local markets, the prices charged for products and rates of production, the number of employees and their wages.

2.2.5.2.2 Import/Export Control

Import and export controls are implemented by means of documents, such as the letter of credit, which is a bank guarantee of payment provided that certain stipulated conditions are met, the draft, which is a written order to pay, and the bill of lading, which covers the actual shipment of the goods by a common carrier and title, and commercial invoices, which describe the goods of the
exporter in terms of prices, volume, financial terms and the location of delivery.

The insurance certificate is also useful for indicating the goods shipped. Consular invoices which are issued by the importing country are useful for customs purposes. In addition there are certificates of analysis, packing lists and export declarations. Variations in each of these documents provide a variety of ways to accommodate any type of transaction. All of these documents help government authorities to control MNE trade and to prepare import/export statistics.

The host government authorities, e.g. customs officials, the department of trade, planning and supervising ministries, the central bank and the government auditor, can therefore investigate imports and exports in relation to quantity, quality, prices, timing and other considerations. These procedures can serve not only to make sure that enterprises carry out the duties imposed on them by local legislation, but also to determine the net impact of the trade activity of the enterprise on the balance of payments.

### 2.2.5.2.3 Employment

MNE should be required to prepare an employment report, which would include details of its labour policy; the number of employees, indicating their nationality; labour turnover; accident rates; and employee costs, including social expenditures and costs of training. The government auditor starts by examining the MNE employment policy to make sure that it is consistent with national development plans.
The subsidiary may subsequently be asked about the number of jobs created each year, which will be compared that estimated in the feasibility study. It is also necessary to know employment turnover and productivity, and the number of workers who have received training, the effectiveness of the training programmes, the classification of skill levels, and the daily and weekly hours worked. In addition, comparison with local enterprises should be made. For instance, a comparison between employment levels in foreign and local enterprises would be useful in revealing the incentives which attract the labour force to MNE's.

2.2.6 Performance Evaluation of Foreign Operations

Performance evaluation by the host is very different from the internal performance evaluation. Choi and Mueller (1984, p. 404) claim that the internal performance evaluation system of a subsidiary is designed to permit top management to:

(a) judge the profitability of existing operations;
(b) spot areas that are not in control;
(c) allocate limited corporate resources productively; and
(d) evaluate managerial performance.

In contrast, the purpose of evaluation by the host country is to measure the foreign subsidiary's contribution to the host country's economic and social objectives. The performance indicators mentioned earlier will be used to evaluate the real effects of a foreign enterprise on the host country in terms of:
1. contribution to national output;
2. contribution to employment;
3. contribution to balance of payments;

In addition to the above main performance indicators, there are the important effects of foreign subsidiaries in relation to externalities and social performance, that is, social costs and benefits occasioned by MNEs operation. These effects should be considered as inputs and outputs related to the project for the purpose of evaluating it from the social point of view.

The evaluation of enterprise performance starts with gathering the required data from the financial statements, the value added report, the import/export report and the employment report.

The operations are then evaluated for the purpose of:
1. Ascertaining that the enterprise has generated a reasonable local value added relative to that stated in its feasibility study.
2. Ascertaining that the enterprise has created new jobs for local workers and increased their skills.
3. Measuring the enterprise's ability generation of foreign currency and its efficiency in the use of its resources.

If the performance is satisfactory, this means that the enterprise is consistent with the country's objectives. If it is unsatisfactory, the government must ask the enterprise's management to change its plans in order to meet the country's needs in accordance with the terms of the
concession agreement.

2.3 Conclusions

The main purpose of this chapter was to outline a theoretical framework for the host government control of MNEs. To this end, the general control model as it appears in the accounting literature was reviewed.

It was argued that the control process is a closed loop comprising a number of elements. The process begins with the setting of goals and strategies. Actual performance is then measured and compared against the plans and the state objectives. Feedback of any deviation is followed by corrective action as necessary. The whole cycle is continuous.

The chapter then discussed the economic and financial criteria which should be used as a basis for entry decisions and for controlling and evaluating performance. Economic criteria were seen to include local value added, creation of employment, and effects on balance of payments. Financial criteria include the accounting rate of return and Net Present Value.

The control structure was then discussed. The role of the relevant ministries in evaluating and following up project feasibility studies was examined, and particular emphasis was placed on the role of the government auditor. It was argued that traditional external audit is inadequate for host government purposes, and that the government auditor must have the right to investigate the MNE, conducting not only financial and compliance audit, but also
effectiveness and efficiency audits. It was recognised that this might require stronger government audit departments and specialised training of personnel.

The control model was then explored in practice. Entry control was considered, and the necessary technical, financial and economic analysis discussed. In addition, the importance of the Concession Agreement was emphasised. At the operating stage, attention would be paid to the MNEs behaviour in respect of remittance of funds abroad, currency impact, transfer pricing, and taxable profit. The government auditor again has a key role here.

A further control mechanism would be the administrative control system whereby the government intervenes directly in such areas as production, imports and exports, and employment policies.

Finally, the control loop is closed by performance evaluation of the enterprise, by which its real contribution to the host country is assessed in terms of the performance indicators discussed in this chapter.

In the third part, this model will be used to evaluate the control system currently operated over MNEs in Egypt, using Squibb Egypt as a case study, to ascertain how the current system might require improvement. To this end, the next part is devoted to discuss in detail the development of foreign investment in Egypt, indicating its impact on the economy under Open Door Economic Policy (ODEP) and review the current control system operated by the government.
Part II

Foreign Investment In Egypt - An Overview
Chapter III

Foreign Investment Development - A Historical Review

3:1 Introduction

This chapter deals with three main issues. First, it deals with the development of the Egyptian economy since the early 1950s, with special reference to investment allocation to economic activities and to the political and other factors which have influenced this development. Second, it deals with the economic policies that have influenced the flow of foreign investment and the legal framework for establishing foreign enterprises. Third, it deals with the legal form of foreign investment under the open door policy and its contribution to national income, employment, balance of payments, etc.

The above approach gives a general idea of foreign investment under various economic policies, and the main reasons behind the government's adoption of an open door policy. Also it provides basic information which will help towards an understanding of the government control techniques over MNEs.

In the light of the above, discussion of the development of foreign investment is divided into two main sections. The first section deals with the policies which have governed the foreign investment inflow to Egypt since the 1950s. The second section appraises foreign investment and its contribution under the open door policy.
3.2 Foreign Investment Policies and the Economy: Historical Background

Before 1956, the Egyptian economy was dominated by private capital including foreign investment capital, i.e., it was a free market economy with limited government intervention and regulation. Between 1956-1973, as a result of a series of nationalisations, the economy became an almost completely planned system. After 1973, the government changed its attitude and decided to go back to the free market system but with government intervention in, and regulation of, the economy.

Accordingly, this section considers foreign investment policy in three distinct stages:

1. Predominance of the free market prior to 1956.
2. The socialist and planning system (1956-1973).
3. The adoption of the open door policy after 1973

3.2.1 Predominance of the Free Market prior to 1956

Before 1952, two development phases characterised the Egyptian economy (EL-Kammash, M., 1970, p.39). First, it was transformed from a monopolistic economy during Mohammed Ali's rule to a free market system during the reign of his successors. British rule and the wars led to the integration of the Egyptian economy into the western economic system, and increasing dependence on the export of cotton.

Second, the economy became heavily dependent on private enterprises rather than public enterprises, so that state attempts to control the economy were unsuccessful. It is estimated that the public sector accounted for only 13% of
the GDP, while the private sector provided the remaining 87% (Ikram, K., 1980, p.17). Foreign investment went primarily to the export sector and the services associated with it. The agricultural sector retained a primary role in the economy until the advent of the socialist regime in 1952.

Between 1952 - 1956, the general situation of the economy remained unchanged, despite radical political and social developments. Externally, significant political gains were made with both the Eastern and Western blocs. Internally, the regime proved more authoritarian than the old regime, and resisted demands from the Egyptian bourgeoisie for a return to party politics, although businessmen were consulted on matters directly affecting the business community, and representatives of the Federation of Egyptian Industries or Misr Group sat on nearly all the newly created National Councils of Development.

From the political point of view, the new regime seemed favourably disposed towards liberalisation. Nasser and other leaders emphasised the importance of private capital and the need to encourage it in every way possible. To this end, the new government established the Permanent Council for National Production (PCNP) in 1952 to increase the pace of economic development and to restore economic stability. In 1953, foreign companies were offered freedom under Law No. 156 to transfer profits resulting from investment on condition that they did not exceed 10% of the registered capital investment and were in the same currency as the
original investment; they were also free to repatriate capital after five years from the date of coming to the country, to a maximum of one-fifth of the value of capital each year. This law was modified by Law No 475 of 1954 to allow for more flexibility in the area of profits and capital remittances. However, despite these incentives, the flow of foreign capital investment was very small (Driscoll, R., et al, 1978, p.6).

The economic developments of the period also took place as a result of the political decisions of the new regime. For example, in agriculture, many important projects were initiated, starting with the land reform of 1952, in order to increase agricultural output to develop the industrial sector and to cover the demands of the population (Abdel Fadil, M., 1975, p.192). The average total investment in the agriculture sector was estimated at $33 million, i.e. 11 per cent of the total investment of the economy during the period 1952-1956. In addition, its contribution to Gross National Product amounted to 20.8 per cent, and its rate of growth was estimated at only 0.4 per cent per annum during the same period (El-Kammash, M., op.cit, pp.291-293). Further, the total increase of land cultivated was estimated at 10 per cent during the same period, while the population increased by about 80 per cent (Al - Gritly, A., 1977, p.295).

In the industrial sector, the regime set up several new industries and modernised traditional industries in order
to raise industrial productivity and promote the growth of the economy as a whole (O'Brien, P. 1966, pp70-72).

Official indices show that industrial production increased by 30 per cent between 1952-1956 as a result of diversification and the introduction of new industries (El-Kammash, M., op. cit, p.297). Investment expenditure in industry, which amounted to $81.2 million in 1952-1953, increased steadily to reach $119.6 million in 1955-56. This meant that a change took place in the pattern of investment in industry in order to meet local market demands and export needs (Issawi, C., 1963, p.52).

Overall, the Egyptian economy during this period was dominated by the private sector. However, the inflow of foreign capital was meagre. One explanation is that foreign enterprises hesitated to come to Egypt during the years following the revolution because they did not trust the new regime. Foreign investment in general requires not only legal guarantees but also practical guarantees and a stable investment climate, which were lacking during the politically uncertain years following the revolution.

3.2.2 The Socialist and Planning Phase (1956-1970)

During this period the Egyptian economy entered a new phase, including the nationalisation of the economy and the movement towards socialism and a planning system.

During 1956 -1960, the new government attempted to bring the majority of the country's resources under the control of the public sector. Several political and economic factors caused this (Hafiz, H., 1966, p.207, and Shafik, R.,
1. There was a lack of funds to finance the High Dam project and improve the economy.

2. Diplomatic conflicts arose with the Western countries, especially Britain, the U.S.A and France, as a result of several issues such as the Baghdad pact, the tripartite arms embargo, the High Dam controversy, and the Anglo-French-Israeli attack.

3. A new constitution emerged to achieve the social and economic objectives of the country.

These events paved the way for nationalisation and for a big push toward socialism and central planning. To that end, the government issued a series of laws to nationalise all foreign companies, including the Suez Canal Company in July 1956. For example, laws No. 22 and 23 of 1957 Egyptianised all banking and insurance, while law No. 24 stated that export and import agencies and commercial representatives should be owned by Egyptian citizens. Law No. 153 of 1957 prevented the founding of any company without government authorisation; law No. 21 of 1958 made it necessary to obtain a government permit to set up or expand an industrial establishment or change its location or production.

Law No. 114 of 1958 regulated the number of directors of companies while law No. 115 in the same year enforced the use of Arabic in business establishments. In early 1959, law No. 7 stipulated that companies must set aside 5 per cent
of their net profits for the purchase of government securities, after distribution of dividends equal to at least 5 per cent of their capital. Future distribution of profits was also regulated. Presidential Decree No. 258 of 1959 subjected thirteen public utility companies to the control of the state Audit Department (National Bank of Egypt, 1961, p.23). As a result of these developments, the private sector was relegated to a marginal role, and the economy in general became an almost completely planned system, subject to government control.

With regard to economic development, overall investment during this period increased from $347.3 millions in 1956-57 to a total of $394.2 million in 1959-1960 (El Kammash, M., op.cit, p.288). The foreign component was reduced, while local investment increased, reaching $392.4 millions by 1959-1960 (Department Of Statistics and Census, 1962). Also, a considerable change took place in investment distribution in the Egyptian economy during this period, from concentration on service sectors at the outset of the period, to industry as top priority.

Gross National Product increased over this period from L.E. 1.046 billion in 1956 to L.E. 1.3 billion in 1960, with a noticeable increase in annual per capita income, though with a downward trend during 1959-1960 (IMF, 1987, p.469). The industrial sector increased its share of GNP by a significant amount over the period, though the rate of increase fluctuated, reaching a peak in 1957-8 and dropping sharply in the two following years (Aliboni, R., et al, 103
Agricultural production increased as a result of the adoption of new policies. O'Brien (op. cit, pp.96-97) classified the agricultural policies of the regime into two types: horizontal policies, related to the expansion of the area of land and the quantity of irrigation; and vertical policies concerned with the productivity of land and workers.

Land reclamation was also important. By the end of the 1960s, 400,000 faddans had been developed by land reclamation companies which sold to landless farmers about 150,000 faddans.

Many jobs were created in both production and service sectors, and the total labour force rose from six million workers in 1959 (24 per cent of the population) to 7.725 million workers in 1960, 29.7 per cent of the population for that year (CAPMS, 1963). The production sector absorbed nearly 70 per cent of total labour; agriculture took the largest share of the labour force, 49 per cent, whilst the industrial sector share reached 21 per cent, compared with only 8.5 per cent in the 1952/56 period. However unemployment still existed as a consequence of population growth, lack of education etc.

In conclusion, the 1956-1960 period was characterised by the new impetus towards progressive Egyptianisation and nationalisation of the economy. In this stage, the major foreign-owned enterprises were nationalised. At the same
time, the first Five-Year plan for industry was launched, as well as general plans for economic and social development. During this period also, several government organisations were created to regulate economic activity. As a result of these measures, capital formation came under the control of the government authorities, so that Egypt became a quasi-socialist state.

The sixties saw a series of laws directed at more nationalisation, together with the enactment in 1962 of the National Charter, which emphasised that economic development had to be based on socialism (Ikram, K., op. cit, p.21). By virtue of these laws and the National Charter, companies of mixed public and private ownership were brought into full public ownership (Aliboni, R., et al, op. cit, p.136). The flow of foreign investment was also made subject to the approval of the president, who had to issue a presidential decree for each project involving foreign participation.

To achieve the desired economic objectives during this period, a ten-year General Plan was drawn up for the country as a whole. This plan specified the goals that needed to be achieved by each economic sector and the interrelationship among these sectors (Briston, R., et al, 1985). Its main overall aim was to double national income over the planning period, necessitating an expansion in domestic output at an annual compound rate of 7.2% (National Bank of Egypt, Vol. 17, No.1, 1971, p.162).

Overall estimated investment required for this plan was L.E. 3293 million, almost half of which would be invested in
the first five-year period. In fact, actual investment over the ten year period corresponded quite closely to the planned target, i.e. 81.5% (Ibid, p.163).

A report of the U.K. Department of Trade and Industry identified a number of constraints on agricultural growth. First, only 2.5% of Egypt's total land area was cultivated, and despite reclamation and the increase in the cropped area, the per capita share of cultivated area declined from 0.23% to 0.18% and the cropped area from 0.39% to 0.33%. Secondly, the improvement in industry was at the expense of agriculture, and thirdly, government price policies led farmers to reduce the major controlled crops and to grow uncontrolled profitable crops (U.K. Dept. of Trade and Industry, 1976, p.25).

As for industry, although its share in total investment was high, its share in total output rose only from 25% in the base year (59-60) to 34% in 1969/70. In reporting the performance of the industrial sector, the Egyptian Ministry of Planning attributed the inefficiency of that sector to a number of factors: over-dependence on imported raw materials and equipment, decreased foreign exchange allocated for imports of these requirements, employment and pricing policies, and idle capacity, with capacity utilisation for the sector estimated at only 70% with many factories working under this rate (National Bank of Egypt, 1972, p. 166).

However, some sectors, e.g. transportation and communications, surpassed the targets for the two five-year
plans. Despite the gap between planned and actual results, attributed to internal and external constraints, the overall growth rate of the economy during the sixties represented a considerable improvement on its performance in the fifties. By the end of the 1969/1970 plan, the value of total production at 1959/1960 constant prices was L.E. 4286 million, the target being L.E. 4941 million. Output rose to L.E. 2089 million (target: L.E. 2564 million) and employment to 8,275 million (target: 8,936 million). The rate of growth in national income came close to the target for the period as proposed by the planning committee in its preliminary studies. Thus the two five-year plans achieved a considerable success.

The value of agricultural production increased from L.E. 581.6 million in 1959/1960 to L.E. 679 million by the end of the first plan, and to L.E. 764.4 million by 1969/1970. This resulted in the value added by agriculture reaching L.E. 477 million, i.e. an increase of 29.6 percent, by the end of the ten-year period (Ibid, pp.169-175).

The share of industry in total production was estimated at L.E. 1689 million by the end of the first five year plan, compared with L.E. 1207.2 million in 1959/1969, and increased to L.E. 2075 million by the end of the ten-year plan (Ibid).

With regard to employment, the total labour force in 1960 was nearly seven million workers, increasing to more than eight and a quarter million by the end of the 1970s (CAPMS, 1975, p.32). The average increase in total
employment was 1.2 per cent, while the average increase in the population was around 2.5 per cent. Thus actual employment corresponded closely to the plan’s target by the end of 1970.

Although the number of employees in the industrial sector, namely 799 thousand workers, had increased by 66.1% over the base year 1969/70, (National Bank of Egypt, op.cit, pp.170-175) this represented only 12% of total employment, while agriculture, the largest sector, absorbed about 49% of the total. Another significant increase was in the government sector, where the number of employees rose by 70% to 1,200,000 by 1970, though the increase in the total labour force was little more than 20 per cent of the population increase (Ayubi, N., 1980, pp.243-244).

As for the balance of payments, there was a persistent deficit attributable to the failure of exports proceeds to pay for imports, and of agricultural and manufactured output to meet the increase in domestic demand for essential items (Amin, G., 1981, pp. 430-441).

Overall, during the sixties the development process, under state central planning, was severely weakened. This was explained partly by the decline in investment since the mid-sixties and partly by the decline in the efficiency of the public sector and a slowdown in overall economic progress. This could be attributed to the events in Yemen, the 1967 war, the closure of the Suez Canal and the weak role of foreign investment, which would later prompt
Sadat's open-door policy.

With the beginning of the 1970s, Egypt entered a new political stage under President Sadat who succeeded Nasser at the end of 1970. However, until 1975 the picture of the economy remained as it had been during the sixties, for the same reasons mentioned above, together with preparation for the war against Israel. For these reasons, together with the need to develop the economy, the government changed its attitude toward the public sector and sought to adopt a new economic strategy. As a consequence, after the declaration of a "corrective movement" on May 1971, the first comprehensive law concerning foreign investment was introduced, offering a number of incentives to foreign direct investment (Carr, D., 1979, pp.41-42 and Driscoll, R., et al op.cit, pp.10-12).

1. Capital repatriation was allowed after five years in the currency of receipt and at the prevailing rate of exchange.
2. Profit remittance was permitted at the prevailing exchange rate.
3. Profits were exempted from tax for five years.
4. Compensation was allowed in the event of nationalisation.
5. Foreign currency earnings could be used for payments for imported material and machines.
6. It was planned to create a General Authority for Investment and Free Zones to study investment projects, to ascertain investors' requirements, and to provide
other information and facilities. The investment fields included in this law were tourism, advanced technical projects, housing, trademarks, and services.

In accordance with this new orientation total investment during 1971-73 increased by some 1.1 per cent, i.e. L.E. 358.5, in 1971 and during 1973 by 16.8 per cent, i.e. L.E. 466.7, (Ministry of Planning, 1982, pp.162-163). Investment was apportioned between the leading sectors of the economy so as to achieve a high rate of growth within a framework of economic equilibrium, taking into consideration world conditions. However, investment during 1970-1973 was lower than during the sixties (Amin, G., op.cit). The lack of funds available for investment, attributable to the direction of resources towards the war effort, and the lack of foreign capital investment, was reflected in the slow growth of the economy.

With regard to national production, the rate of growth was 7.3 per cent in 1971, and 7.93 and 12.5 per cent in 1972 and 1973 respectively, all major sectors contributing to this steady increase. Output for the economy as a whole reached L.E. 2977 million in 1971, i.e. 5.5 % higher than the comparable figure in 1969/70. In the next two years, it rose by L.E. 3209.9 and 3526.1 million, i.e. a 7.5 and 9.2 per cent increase respectively (Egyptian Shoura Council, 1985, pp. 1347-155).

With regard to employment, the labour force increased by 2.3 per cent in 1971 and 5.8 per cent in 1972. However,
despite this increase, the rate of employment in the industrial sector declined, whereas that in other sectors steadily increased. This was attributable to the obstacles mentioned earlier, and the new job opportunities offered by the distribution and services sectors, with higher wages than industry. It should be noted that the services sector was the largest sector, absorbing all new employment. As for wages, there was a considerable rise in the average wage per worker in the years under review, though the increases were not evenly distributed among sectors.

To sum up, the period under consideration was characterised by the rapidity of its political and economic changes, which led to changes in investment strategy, planning and output and employment policies. In fact, the political climate which prevailed in the country at that time, and the attitude of foreign governments, did not produce a sizeable inflow of direct foreign investment to develop the economy. Despite this, reasonable progress was made in production and growth of economic output, although this aim was secondary to the war effort.

3.2.3 The Adoption of the Open Door Policy after 1973

As was seen in the previous section, the years following 1956 witnessed a great increase in the role of the government in the economic life of the country. The private sector was relegated to a marginal role and foreign investment was almost squeezed out. In the late 1960s and the early 1970s it became clear that this economic policy was inefficient, and the government was impelled to change
towards a capitalist policy, after the country's failure during the fifties and sixties to achieve a truly socialist economy. The new policy, which was intended to stimulate economic development and growth and overcome socio-economic problems in Egypt, was known as the Open Door Economic Policy (ODEP).

The new policy, which was introduced in October 1974, was a device to achieve the following benefits (Sadat, M., 1974, pp 4-9):

1. a high rate of socio-economic development;
2. the introduction of modern technology;
3. increased national production and income;
4. increased productivity and per capita income;
5. provision of products formerly not available and improvement of domestic products to meet foreign competition;
6. optimal use of national resources;
7. full integration between the public, private and co-operative sectors;
8. increased employment and technical and administrative efficiency;
9. introduction of new ideas of decentralised management;
10. increased revenue from excise and other duties;
11. provision of foreign currency for investment projects.

To achieve these objectives, the Egyptian government had first to eradicate the bureaucratic inefficiency which had caused some companies to abandon negotiations with the
Egyptian authorities, introducing instead more democratisation in decision-making. Moreover, it was important to liberalise, rather than restrict foreign trade. Finally, the government needed to reorganise the public sector to improve its performance and encourage local private investment to play an active part in the development of the economy.

To cope with the ODEP, attention had to be paid to recent legal developments in the public and private sector, the stock exchange, and the foreign trade and exchange control system, and their role in the Egyptian economy, which created a changed climate for the new policy.

Regarding reorganisation of the public sector, a series of laws and regulations were enacted. The government tried to pave the way for public sector management to counter the competition expected from both private and foreign capital investment in the future. By virtue of Law No. 11 of 1975, the General Organisations were abolished and replaced by "Supreme Sector Councils". Public sector companies were also given more autonomy to establish joint venture projects with foreign enterprises, and thus obtain the same benefits provided by the new foreign investment code. In addition, the managers of public sector enterprises were given more autonomy to take decisions in the area of finance, investment and employment. Generally speaking, the public sector was encouraged to make a positive contribution to the economic open door policy.

Under the new policy, the stock exchange was reopened.
to assist foreign capital investment. Among the new regulations governing the stock exchange were the following (National Bank of Egypt, 1982, pp. 382-383):

1. Shares of companies and projects subject to the investment law were permitted to be circulated on the Egyptian stock exchange in foreign currency.

2. Investors were allowed to assign their shares in projects to others, both in domestic and foreign currencies.

3. Banks were authorised to act as intermediaries in the purchase of bonds and international financial stocks for circulation on the exchange, linking the Egyptian and international stock exchanges through the transfer and settlement of the value of securities in foreign currencies.

4. The ruling which required the allocation of 49 per cent of the shares of joint stock companies to Egyptians was abolished, thus overcoming an obstacle which might hinder the formation of companies.

In an attempt to regulate and reorganise the trade system Law 118 of 1975 was issued. This law gave both the public and private sectors greater freedom to engage in foreign trade by removing impediments to access to foreign markets. The private sector was allowed to import or export most goods without restriction, the exceptions being certain exports (e.g. cotton and rice) and some basic imports, such as foodstuffs, which were reserved for public sector
companies or for specialised government authorities, such as the Central Supply Authority (Abdel Khalek, G., 1981, pp.394-408).

In respect of foreign exchange policy, in 1973 the "Parallel Exchange Market" system was established. Between 1974 and 1977, operations in this market were extended to include all foreign exchange receipts except those from exporting raw cotton, rice, and petroleum, and from the Suez canal, and all imports except those of basic commodities (Abdel Fadil, M., et al, 1984 p.178).

In 1978, the foreign exchange market was reorganised to meet IMF requirements by integrating the official foreign exchange market with the Parallel Foreign Exchange Market in order to unify exchange rates (Ibid, p180). A unified exchange rate (based on an exchange rate of $ 1= LE 0.70) was applied to all receipts and payments operated through the banking system.

However, there were strong market pressures against the unified exchange rate, and in 1981 the government was forced to reserve the exchange rate of $ 1 =LE 0.70 for transactions put through the Central Bank foreign pool, applying a rate of $ 1=LE 0.84 to transactions operated through the Commercial Banks foreign pool (Ibid, p.182).

In addition to the official foreign exchange markets, a black market existed in which rates varied from those prevailing in the Commercial Banks’ foreign exchange pool, by an average of 25% -40% (Ibid). Because of the persistent shortage of foreign exchange receipts, the government was
forced to follow the exchange rates of the black market, as illustrated by several decrees between 1983 and 1987 which amended the foreign exchange control system to meet the requirements of the open door policy. Particularly significant was the establishment in 1987 of a free foreign exchange market.

As for the foreign investment code, the government promulgated Law No. 43 of 1974 concerning the investment of Arab and foreign capital and free zones. Driscoll summarised the major provisions of the law into five areas (Driscoll, R., et al., op. cit, pp. 14-16): capital participation, inflow and outflow of funds, incentives and guarantees to foreign investors, fields of investment projects, and how the law was to be administered by government authorities.

However, this law was not sufficient to promote the level of foreign investment considered desirable for the country's economic development, for several reasons:
1. The description of the types of projects Egypt wanted to encourage was too vague.
2. The position on exchange control and rates of exchange relating to the transfer of profits was not clear enough.
3. The incentives provided were inadequate.
4. The export-orientation areas were unclear.

Following consultation between the government and businessmen, some amendments were made to the law by Law 32 of 1977, in such areas as foreign exchange rates, transfer of profits, tax holidays, greater liberalisation of the
foreign exchange regulations and relaxation of bureaucratic rules.

Another significant improvement was law No. 159 of 1981, commonly referred to as the Companies Law, which offered many advantages to foreign investment, similar to those accorded to local investors. The important changes introduced in the law were as follows:

1. Authorised and unissued shares were allowed, but 25% must be paid-up and 49 per cent must be offered to the Egyptian public.

2. Capital could be in the form of foreign exchange, and the determination of the value of non-cash equity was decided by two or more experts appointed by the president of the district court.

3. 5% of the after tax profits had to be placed in a legal reserve until it reached 50% of the original capital and 10% of the same profits were distributed to workers up to the value of the annual payroll;

4. A minimum of three founders and shareholders were required.

5. A minimum of three directors must be Egyptians.

6. It removed the obligation to allocate 5 per cent of net profit to the purchase of government bonds and to distribute worker bonuses in an amount equal to 30 per cent of net profits.
3.3 Appraisal of Foreign Investment Under The Open Door Policy

The aim of this section is to appraise the contribution of foreign enterprises in the light of various economic and financial indicators, focusing on the growth and development generated by these projects.

3.3.1 Legal Form of Foreign Enterprises Under ODEP

As mentioned before, foreign investment in Egypt is governed by three main laws, namely Law 156 of 1953, Law 43 of 1974 and Law 159 of 1981.* According to these laws foreign capital can only enter the market by the formation of joint ventures with Egyptian capital. However, other forms of enterprise are allowable, such as foreign wholly-owned subsidiaries or local wholly-owned companies. Projects may be established entirely with Egyptian capital by Egyptians, or entirely with foreign capital by foreign nationals with the approval of two-thirds of the Investment Authority Board, including the General Companies Administration. Although Law 159 of 1981 was not intended to promote foreign investment, many of its provisions affect foreign corporations operating in Egypt, and foreign investors may use Law 159 rather than Law 43 to establish joint ventures.

The term "joint venture" is generally used to refer to the establishment of a project with foreign and local (public or private) capital involving the incorporation of an Egyptian legal entity such as a joint stock company,

* Some regulations of foreign companies operating under Law 156 now come under Law 159 of 1981.
limited liability company, partnership, or individual. However, although the term is used in Law 43, it is not defined in this or any other Egyptian law. The law does not stipulate a required minimum percentage of local participation for all ventures. However, in the case of banks engaging in local currency transactions, at least 51% of the capital should be Egyptian, while construction projects must take the form of joint stock companies with a minimum Egyptian share of 50 per cent. Article 23 of Law 43 states that:

"Joint ventures established under the provisions of this Law in the form of joint stock or limited liability companies shall specify in their Articles of Incorporation the names of their respective contracting parties, the legal form of the company, its name, purpose of activities, duration, capital, percentage of participation by Egyptian, Arab, and foreign parties, and methods of subscription....In all joint ventures the General Authority for Foreign Investment and Free Zones shall have sole competence to review and approve, in compliance with the provisions of the present law, the Articles of Incorporation."

Under Law 159 of 1981, joint ventures may also take a number of legal forms. These include joint stock companies, limited liability companies and simple partnerships. However, under Law 156, joint ventures formed as joint stock companies must have a minimum of 51% Egyptian participation.

In addition, foreign investment laws also permit local wholly-owned enterprises under special conditions for the purpose of realising economic and social development objectives. The local wholly-owned company is a project with 100% local ownership, and may take the same forms as joint venture companies operating under laws 43 and 159. In
all cases, the equity participation is a matter for discussion between the Egyptian founding shareholders and the Investment Authority, General Money Market Authority and General Companies Administration.

It is also possible under Law 43 to set up a wholly foreign subsidiary, completely owned and controlled by foreign parent companies, while wholly foreign-owned limited liability companies may be established under Law 159. In these cases, special approval is required from both the Investment Authority Board and the Companies Department of the Ministry of Economic and Foreign Trade.

It can be seen from the above discussion that foreign investment has taken several legal forms:

1. **Joint Stock Company (Shareholders Company):**

   This is a company with capital divided into shares of equal value, whether confined to its founders or available to public subscription. Under Law 43, the minimum number of founders of a joint stock company is two, while under Law 159 it is three. However, both laws stipulate that the articles of incorporation should be signed by the founders or their legal representatives. These signatures should be witnessed by the Egyptian Government’s Notary Public Department or at one of the Egyptian Consulates abroad. Additionally, registration of a joint stock company is effected by delivering certain documents stating the name of the company, its purposes, capital formation, classes and nominal value of shares, and other data required by law; and
paying one quarter of one percent of the capital of the company not exceeding L.E. 1000 to the commercial registrar, to cover fees and duties.

The minimum issued capital of a company placing shares for public subscription should be five hundred thousand Egyptian pounds. 49%* of both issued capital and increase of capital should be available for public subscription to Egyptian citizens, whether individuals or entities. If the founders of the company are not placing shares for public subscription, the minimum capital issued should be not less than L.E. 250,000.

In order to set up such a company, a ministerial decree must be issued. This is done upon request, providing the following documents are submitted:

(1) The statutes and articles of incorporation of the company signed by the founders whose signatures are notarised;

(2) A certificate attesting that one quarter of the cash capital of the company has been deposited in one of the banks registered at the Central Bank of Egypt; and

(3) The report of experts appointed by the Authority and Money Market Authority to evaluate any contributions in kind.

Finally, the statutes and articles of incorporation of a joint stock company must be published in the official gazette. The company is considered as a legal entity from

* Joint stock companies founded according to Law 43 are exempted from this requirement.
the date of such publication. In addition the shares of those companies which have made issues for public subscription must be presented, not later than one year from the date of closure of subscription, to all stock exchanges in Egypt, to be listed in conformity with their regulations. The Administrative Board of the company is appointed by the General Assembly. Under Law 159, the majority of directors must be Egyptian, but there is no such requirement under Law 43.

2. Limited Liability Company:

According to Articles No. 4 and 8 of Law 159,* a Limited Liability Company (LLC) has not less than two, and not more than fifty partners. The responsibility of each is limited to the contribution made. The company cannot be formed through public subscription and is not allowed to issue shares or bonds. This means that the company's founders are its owners. However, the company is normally run and controlled by directors appointed by its founders subject to financial review by its auditors. The articles of incorporation should be signed by all founders and notarised. The application made by the company must specify the names of founders, whether individuals or entities, their nationality, places of residence, capital of the company divided into shares, types of shares and their distribution among founders, names of directors designated to run the company, either from among the founders or

* Law 43 does not define such companies.
otherwise, names of Control Council members, and the name of the external auditors.

The establishment application for the LLC should be submitted to the Authority or Administration enclosing ten copies of the company's contract, a certificate issued by the Commercial Registration Department, and a certificate from the bank confirming the amount of capital subscribed. The capital of an LLC should be not less than Fifty thousand pounds and divided into equal shares, the value of which should be not less than one hundred Egyptian pounds.

After the final investigation process and the declaration of the company's contract at the Commercial Registration Department, the company acquires the status of an independent entity. The contract of constitution and statutes are published at the date of approval by the Committee for the establishment of the company. Under Article 5 of Law 159, a LLC may not be established to deal in insurance or perform banking services.

It is also possible, for one person or more to form, by registration under both laws, a company with or without limited liability. Four types of company are recognised: (A) commandite company with shares; (B) partnership; (C) simple commandite company and (D) Individual enterprise.

With regard to the first, Article No.3 of Law 159 states that a commandite company with shares may exist in two forms. The first includes one or more joint partners with unlimited responsibility for the liabilities of the company, the second includes shares of equal value
subscribed by more than one shareholder. When the full amount has been paid, the shareholder has no further liability for the company's debts. There must be no less than two founders, and the contract should name at least one of the partners in the management of the company. In addition to the above, commandite companies with shares are governed by the provisions for joint stock companies in the two laws.

With regard to the remaining categories there is no definition in either Law 43 or Law 159.

Egypt's foreign investment policy is thus governed by three laws working together to stimulate productive investment. However, although each law has the same national objectives, they vary considerably in application and method (Davies, M., 1986, pp.9-17). Figure 3.1 indicates broadly the differences between the three laws.

**Figure 3.1**

Principal Differences Among Companies Incorporated Under Law No. 156, 43 and 159

<table>
<thead>
<tr>
<th>Requirement or Conditions</th>
<th>Law No. 156</th>
<th>Law No. 43</th>
<th>Law No. 159</th>
</tr>
</thead>
<tbody>
<tr>
<td>Incorporation procedure</td>
<td>Application to the Ministry concerned for approval of incorporation of company.</td>
<td>Application to the Investment Authority for approval of project and incorporation of company.</td>
<td>Application to Companies Administration for approval of incorporation of company.</td>
</tr>
<tr>
<td>Ministerial approval</td>
<td>Included under &quot;Incorporation procedure&quot;</td>
<td>Included under &quot;Application procedure&quot; explained in Chapter Four, and based on feasibility study.</td>
<td>Application necessary depending on the project to be carried out.</td>
</tr>
<tr>
<td>Capital</td>
<td>Subject to the agreement and legal requirement of law.</td>
<td>No minimum capital requirements except for &quot;Investment Companies&quot;</td>
<td>Minimums are established by Law No. 159. Higher amounts are required if</td>
</tr>
<tr>
<td><strong>Egyptian participation</strong></td>
<td>Majority control is Egyptian, i.e. 51%</td>
<td>Proportions fixed by the law in certain cases, otherwise subject to negotiation with partners and authorities. In most cases majority ownership by foreign equity is possible.</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td><strong>Proportion of Egyptian Directors</strong></td>
<td>Majority must be Egyptian in the case of joint stock company.</td>
<td>Exempt from the requirements of a Law No. 159 joint stock company.</td>
<td></td>
</tr>
<tr>
<td><strong>Employee participation in management</strong></td>
<td>An assistant administrative committee must be set up once employees reach a certain number.</td>
<td>An assistant administrative committee must be set up once employees reach a certain number.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>One of three alternative methods must be selected. * First is similar to those of the committee formed for a Law 43 company; * Second is the election of employee representatives to the board; * The third method provides for the issue of employee shares with the right to appoint representative directors.</td>
<td></td>
</tr>
<tr>
<td><strong>Tax exemptions</strong></td>
<td>Five year exemption from the first year of production.</td>
<td>Minimum 5-year tax holiday: foreign employees exempt from general income tax; interest on foreign currency loans exempt.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>5-year tax holiday if industrial project, conditional on using more than 50 workers, 10 years if land reclamation in new city.</td>
<td></td>
</tr>
<tr>
<td><strong>Foreign currency accounts</strong></td>
<td>Right to operate such accounts governed by exchange control legislation.</td>
<td>Right to operate such accounts contained in, and controlled by, Law No. 43.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Right to operate such accounts governed by exchange control legislation.</td>
<td></td>
</tr>
<tr>
<td><strong>Remittance of profits</strong></td>
<td>Profits resulting from company operation can be transferred as follows: * Pharmaceuticals (60-70%) * Hotels (6-25%) * Petroleum (100%) * Financial (100%)</td>
<td>Profits transferred subject to the approval of the Board of Directors of Authority in both cases. Use of free market plus right to purchase foreign currency in that market guarantors contained in Law.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Use of free market but no guaranteed right to purchase foreign currency. Use of prevailing rate right to purchase foreign currency from free market.</td>
<td></td>
</tr>
<tr>
<td>Repatriation of capital</td>
<td>No formal restrictions</td>
<td>Five years from the date of project establishment to maximum 20% unless special permission granted.</td>
<td>No formal restrictions</td>
</tr>
<tr>
<td>------------------------</td>
<td>-----------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Fees and Royalties</td>
<td>All fees and royalties are allowed to be remitted subject to government approval.</td>
<td>The law permits 50% of fees to be transferred and royalties up to 20% as a maximum value.</td>
<td>No formal restrictions.</td>
</tr>
<tr>
<td>Using local materials and other component of production</td>
<td>At highest declared international rates.</td>
<td>The same condition as Law No.156.</td>
<td>At subsidised prices prevailing in the country.</td>
</tr>
<tr>
<td>Protection against expropriation</td>
<td>Protection in Constitution and in bilateral agreements.</td>
<td>Protection in Constitution and in bilateral agreements</td>
<td>Protection in Constitution and in bilateral agreements.</td>
</tr>
<tr>
<td>Customs exemption</td>
<td>No exemption</td>
<td>Complete exemption may be granted or payment deferred.</td>
<td>No exemption unless project is in a new city or provided for in other legislation.</td>
</tr>
<tr>
<td>Import/export regulations</td>
<td>No exemptions</td>
<td>Exemptions</td>
<td>No exemptions</td>
</tr>
<tr>
<td>Supervision</td>
<td>The law is administered through two responsible departments as follows: * General Directorate for Foreign Currency; (Dept. of Foreign Investment) * General Companies Administration</td>
<td>By General Authority for Foreign Investment and Free Zones and other government agencies, where applicable.</td>
<td>By main two responsible Departments; General Companies Administration and General Money Market Authority and other government agencies depending on the project.</td>
</tr>
</tbody>
</table>

Sources: (1) Law No.156 of 1953 and its Executive Regulations, Cairo, 1953.  
(2) Law No.43 of 1974 and its Executive Regulations, Cairo, 1977.  

However, in December 1989, Law No. 230 replaced Law 43 of 1974, to overcome certain shortcomings in the area of incentives and guarantees to foreign investors. The new law aims to:

1. create more favourable conditions for foreign investment;
2. secure the benefits of all parties;
3. offer foreign investors incentives and guarantees against non-economic risks.
4. strengthen the private sector role in economic development.

The major changes brought about by the new law are as follows:

1. The law permits foreign capital to be set up in the form of partnership companies, joint stock companies, limited partnership with shares, or limited liability companies. Unlike the previous law, it makes no stipulation regarding local participation. It does, however, state that the company's capital must be denominated in the Egyptian pounds (Article 49).

2. Invested capital brought by the project may be provided in cash (free foreign currency) or in kind (tangible and intangible assets). Either form will be calculated at the highest rate of exchange as announced in the Free Market at the date of transfer. Facilities or loans to the project shall not be considered as invested capital (Article 5).

3. The invested capital may be repatriated, at the request of the concerned party, and with the Board's approval, in full or in five equal instalments in the same form and at the highest exchange rate in the Free Market at the date of transfer (Article 24).

4. Net profits of foreign projects may be wholly or partly transferred at the highest exchange rate at the date of
transfer within the limits of the credit balance in foreign currency in project's operation account.

5. Goods necessary to the project's operation may be imported without a license, subject to the Authority's approval; in other words, normal import regulations are waived. Moreover, imported capital goods are exempted from customs duties.

6. Projects do not require registration or a permit in order to export their products.

7. Foreign companies operating under the new law are exempted from the following taxes for five years, which may be extended to eight years according to the nature of the project:
   a) Tax on industrial and commercial profits;
   b) Tax on income from movable capital;
   c) General income tax on dividends received by individual shareholders.
   d) Taxes related to a & b above, e.g. defence tax, military and national security taxes, and local taxes.

8. Products of the projects are not subject to government pricing policy, except that basic necessities may be made subject to price controls by ministerial decree, taking into account their economic cost.

9. Foreign companies operating under this law are deemed to belong to the private sector irrespective of their legal structure; thus they are not subject to the regulations relating to public sector companies.
Having discussed the provisions of the three main laws governing foreign investment, we now consider separately the forms of investment companies existing under each law.

3.3.1.1 Forms of Foreign Investment Under Law 156

Many foreign enterprises operating under laws No. 156 of 1953, and 475 of 1954 were allowed to continue in operation even after the application of law 43 of 1974 and its amendment, and law 159 of 1981, with minority control and participation (i.e. 49 per cent).

A report written by the Joint Committee of the Peoples' Assembly pointed out that foreign investment capital up to 1961 amounted to L. E. 8 million, out of which L. E. 5.1 million was directed to petroleum activity.

However, this foreign investment represented only about 3 per cent of the total investment in the economy during the period under review; nationalisation and strict governmental control had resulted in most foreign ownership passing into the hands of the Egyptian government, though foreign companies operating in the national interest were allowed to operate within the public sector, with Egyptian directors and managers.

These companies have taken a number of legal forms. Table 3.1 classifies these into three categories. The first category includes joint-venture shareholder companies, exemplified by the pharmaceutical sector. The first of these companies, Swisspharma, was established in 1965 under law 156, with capital of L. E. 0.28 million, shared by the public
### Table 3.1
The Structure of Foreign Companies Operating in Egypt Under Law 156 of 1953

<table>
<thead>
<tr>
<th>Legal Form</th>
<th>1983</th>
<th>1984</th>
<th>1985</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Joint-Venture</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>as Shareholder Co.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Swisspharma</td>
<td>24.0</td>
<td>26.0</td>
<td>44.0</td>
<td>46.0</td>
</tr>
<tr>
<td>Hoechst</td>
<td>17.0</td>
<td>19.0</td>
<td>26.0</td>
<td>32.5</td>
</tr>
<tr>
<td>Pfizer Egypt</td>
<td>9.0</td>
<td>11.0</td>
<td>10.0</td>
<td>11.0</td>
</tr>
<tr>
<td><strong>2. Foreign Subsidiaries</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Esso</td>
<td>8.0</td>
<td>11.0</td>
<td>42.0</td>
<td>18.9</td>
</tr>
<tr>
<td>Mobil</td>
<td>3.6</td>
<td>7.0</td>
<td>15.0</td>
<td>25.2</td>
</tr>
<tr>
<td>Thomas Cook</td>
<td>2.4</td>
<td>2.6</td>
<td>3.1</td>
<td>4.3</td>
</tr>
<tr>
<td>American Express</td>
<td>1.8</td>
<td>1.9</td>
<td>2.2</td>
<td>2.6</td>
</tr>
<tr>
<td><strong>3. Lease Contracts</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nile Hilton Hotel</td>
<td>6.7</td>
<td>7.5</td>
<td>9.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Sheraton Cairo</td>
<td>4.0</td>
<td>4.9</td>
<td>5.5</td>
<td>6.0</td>
</tr>
<tr>
<td>Marriott Cairo</td>
<td>3.0</td>
<td>4.8</td>
<td>7.5</td>
<td>9.0</td>
</tr>
<tr>
<td>Oberoi of Aswan</td>
<td>2.7</td>
<td>3.8</td>
<td>5.0</td>
<td>6.2</td>
</tr>
<tr>
<td>Etap of Luxor</td>
<td>3.1</td>
<td>4.3</td>
<td>5.6</td>
<td>7.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>85.3</td>
<td>103.8</td>
<td>174.9</td>
<td>179.8</td>
</tr>
</tbody>
</table>


sector and Swisspharma's parent company in Switzerland. The second company, Hoechst, was set up in 1960 with capital assets of L.E. 0.78 million shared between the parent company in West Germany and a public enterprise in Egypt. The third, Pfizer Egypt, was created in 1961 with capital amounting to LE 2.12 million shared between the Egyptian government and Pfizer International in the United States. The investment in capital assets in these companies has
steadily increased during the 1980s. The statutes of these companies specified 51 per cent of Egyptian ownership (i.e. 51 public sector participation) as stipulated in law 156 of 1953.

The second group includes foreign wholly-owned subsidiaries of Mobil and Esso in the petroleum sector, and two service sector companies, branches of Thomas Cook and American Express.

The third group is involved in lease contracts for hotels, set up between multinational enterprise hotels and public and private Egyptian holding enterprises. These hotels are Nile Hilton, Cairo Sheraton, Cairo Marriott, Aswan Oberoi, and Etap of Luxor. The total investment capital of these enterprises amounted to LE 39.3 Million in 1986.

It can be seen that the greater part of capital investment is in pharmaceuticals, followed by petroleum enterprises, even though hotel projects account for the largest number of foreign enterprises, about 38.5 per cent of the total under this law.

The ownership structures of these enterprises vary. The pharmaceutical enterprises have taken the joint-venture form, with 49 per cent participation; the petroleum and services companies have taken the form of foreign wholly-owned subsidiaries, while the hotels are also wholly foreign - owned with full management ownership under lease contract. These divergent structures are attributable to the
economic and political circumstances that prevailed at the
time of their establishment.

3.3.1.2 Form of Foreign Investment Under Law 43

With the passing of law No. 43 of 1974, as amended by
law 32 of 1977, the trend of foreign investment was changed.
In the period 1974-1987, the inflow of direct investment
increased, due largely to more incentives being given to
investors, changes in some economic policies such as the
foreign exchange policy, and several Egyptian public sector
companies allowing participation by foreign investors to
improve their economic position.

3.3.1.2.1 Foreign Investment In Aggregate

The total number of Arab and foreign projects admitted
into Egypt up to the end of June 1987, in various legal
forms, including free zones, amounted to 1643. Their total
authorised capital was estimated at LE 7.7 billion,
including a foreign exchange component of LE 4.8 billion,
i.e. 62.3 per cent of the total (see Tables 3.2 and 3.3).

With regard to projects inside free zones, table 3.2
shows that a total of 281 have been approved, of which 34
were in private free zones. The estimated aggregate capital
of free zone projects represented 18 per cent of the total
capital invested in the economy by foreign investors. The
distribution of these projects actually in operation is
shown in table 3.3.

3.3.1.2.2 Composition of Foreign Investment by
Economic Sector

Table 3.2 provides an analysis of projects approved
under the ODEP in the country as a whole up to 1987. The number of projects in operation amounted to 820. The total

Table 3.2
Projects Approved
Under Law 43 up to 30-6-1987
Value in LE million

<table>
<thead>
<tr>
<th>Approved Projects</th>
<th>Number</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>A: Inland</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In Operation</td>
<td>820</td>
<td>3411.7</td>
</tr>
<tr>
<td>Under Implementation</td>
<td>228</td>
<td>1143.0</td>
</tr>
<tr>
<td>Newly Approved and some Procedures</td>
<td>314</td>
<td>1835.0</td>
</tr>
<tr>
<td>not completed</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1362</td>
<td>6389.7</td>
</tr>
</tbody>
</table>

| **B: Free Zones**                      |        |               |
| Public Free Zones                      | 247    | 1007.1        |
| Private Free Zones                     | 34     | 379.6         |
| **Total**                              | 281    | 1386.7        |
| **Grand Total**                        | 1643   | 7776.4        |

Source: General Authority for Investment and Free Zones

of capital assets in these projects was LE 3.4 billion. Another 228 projects with a total capital of LE 1.1 billion were still under implementation at June 1987. Projects recently approved and still under procedures accounted for 19.1 per cent of the total, with total capital of LE 1.8 billion.

The number of projects approved is attributed to the reduction of bureaucracy and red-tape under the ODEP. The new system ensures that a response to an investment
application is received within one week, and decision-making is decentralised.

With regard to the sectoral distribution of projects inside the country, table 3.3 reveals that the industrial sector comes in first place in terms of projects in operation, with 312 projects, i.e. 38 per cent of the total. These projects have invested capital of L.E. 995.1 million, i.e. about 29 per cent of completed investment in the economy. Agriculture is in the last place, with only 44 operational projects, i.e. 5 per cent of the total, their capital amounting to L.E. 167.2 million, i.e. 4.9 per cent of the total, even though it has been the prime source of the national income since 1952.

The largest category of industrial projects is chemicals which represent 25 per cent, followed by building materials 20 per cent, foodstuffs 17 per cent, and spinning and weaving around 14 per cent. Pharmaceuticals, classified with the industrial sector, had 10 projects approved, i.e. 3.2 per cent with total capital of LE 59.7 million, and a foreign exchange component of LE 34.7 million. Amongst those projects, three have already started to produce pharmaceuticals with total capital assets of LE 31.8 million. Squibb Egypt is one of these projects and will be considered in the third part of this study.

Finance projects in operation accounted for 215 projects or 26 per cent of the total inland, with a gross capital of about LE 1.5 million. These projects are
Table 3.3
Projects Approved Under Law 43 of 1974
Up to 30-6-1987

<table>
<thead>
<tr>
<th>Sector</th>
<th>Approved Projects</th>
<th>Projects In Operation</th>
<th>Projects Under Implementation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NO</td>
<td>Capital</td>
<td>NO</td>
</tr>
<tr>
<td></td>
<td>Local</td>
<td>Foreign</td>
<td>Total</td>
</tr>
<tr>
<td>A: Inland</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial</td>
<td>579</td>
<td>1105.9</td>
<td>1363.4</td>
</tr>
<tr>
<td>Financial</td>
<td>216</td>
<td>809.1</td>
<td>940.5</td>
</tr>
<tr>
<td>Agricultural</td>
<td>108</td>
<td>177.4</td>
<td>178.9</td>
</tr>
<tr>
<td>Construction</td>
<td>194</td>
<td>448.8</td>
<td>207.5</td>
</tr>
<tr>
<td>Services</td>
<td>225</td>
<td>369.7</td>
<td>788.5</td>
</tr>
<tr>
<td>Total</td>
<td>1362</td>
<td>2910.9</td>
<td>3678.8</td>
</tr>
<tr>
<td>B: Free Zones</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cairo</td>
<td>45</td>
<td>2.0</td>
<td>908.6</td>
</tr>
<tr>
<td>Alexandria</td>
<td>114</td>
<td>0.4</td>
<td>308.6</td>
</tr>
<tr>
<td>Suez</td>
<td>41</td>
<td>0.4</td>
<td>81.4</td>
</tr>
<tr>
<td>Port Said</td>
<td>21</td>
<td>1.9</td>
<td>83.6</td>
</tr>
<tr>
<td>Total</td>
<td>281</td>
<td>4.7</td>
<td>1382.0</td>
</tr>
<tr>
<td>Grand Total</td>
<td>1643</td>
<td>2913.6</td>
<td>4860.8</td>
</tr>
</tbody>
</table>

Source: General Authority for Investment and Free Zones, Arab and Foreign Investment Report 30-6-1987, Cairo, Jan., 1987.

concentrated on investment companies and banks. Service sector projects are estimated at 145, i.e. 17 per cent of the total. The nature of foreign projects in this sector varies. The greater portion were tourism enterprises,
followed by medical centres, and private hospitals. Construction projects totalled 104 with total capital of L.E. 187.7.

It is evident that industry holds the first place amongst the economic sectors (see table 3.3). Agriculture, which for many years held first place, now ranks relatively low both in number of projects and invested capital. This clearly reflects the trend of Egypt's recent economic development under the open door policy.

3.3.1.2.3 Ownership Structure of Foreign Companies Under Law No.43

Table 3.4 indicates the legal form of approved companies under law 43 and its amendments up to 30/6/1987. The number of joint stock companies amounted to 886, i.e. 65 % of the total with a total capital of LE 4821.3 million. These are followed by partnership companies, accounting for 29.8 per cent of the total. 34 projects were limited liability, and the remaining 34 projects, i.e. 2.5 % of the total, took the form of foreign subsidiaries of multinational enterprises with a total capital of LE 131.1 million. The subsidiaries' activities are concentrated upon the chemical and petro-chemical industries, spinning and weaving, pharmaceuticals, banks, and special engineering.
Table 3.4
The Legal Form of Projects
Under Law 43 of 1974
Up to 30/6/1987

<table>
<thead>
<tr>
<th>Sectors/ Companies</th>
<th>Joint Stock</th>
<th>Limited Liability</th>
<th>Others*</th>
<th>Subsidiaries</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial</td>
<td>327 1994.0</td>
<td>20 40.6</td>
<td>223 1039.2</td>
<td>9 63.2</td>
<td>579 2468.8</td>
</tr>
<tr>
<td>Financial</td>
<td>228 1667.7</td>
<td>2 6.3</td>
<td>7 10.2</td>
<td>22 45.6</td>
<td>256 1749.5</td>
</tr>
<tr>
<td>Agricultural</td>
<td>72 305.6</td>
<td>3 6.8</td>
<td>33 44.1</td>
<td>na na</td>
<td>108 356.5</td>
</tr>
<tr>
<td>Construction</td>
<td>142 282.3</td>
<td>na na</td>
<td>52 374.2</td>
<td>na na</td>
<td>194 656.5</td>
</tr>
<tr>
<td>Services</td>
<td>121 572.2</td>
<td>9 7.0</td>
<td>92 556.7</td>
<td>3 22.3</td>
<td>225 1156.3</td>
</tr>
<tr>
<td>Total</td>
<td>866 6821.8</td>
<td>34 60.7</td>
<td>407 2024.4</td>
<td>34 131.1</td>
<td>1362 6389.7</td>
</tr>
</tbody>
</table>


* This includes commandite companies with shares, partnerships, and simple commandite companies.

3.3.1.3 Forms of Foreign Investment Under Law No. 159.

Another form of foreign investment in Egypt is found under the Companies Law (Law 159 of 1981), intended to rationalise the treatment of all private investment, local or foreign. The new law is applicable to joint-stock companies, limited liability companies, and commandite companies with shares and is not prejudicial to any provisions of the special laws concerning the public sector or Arab and foreign investment.
3.3.1.3.1 Foreign Investment In Aggregate

Up to the end of December 1986, 1014 private investment projects were approved under the companies law, with a total capital of LE 752.3 million, more companies than the total established during the previous 20 years under Law 26 of 1954. Companies established under Law 159 include agricultural, light industrial, and construction concerns.

Table 3.5 indicates the development of foreign investment participation during the 1982-1986 period.

<table>
<thead>
<tr>
<th>Year</th>
<th>Foreign Capital</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>0.5</td>
<td>2.5</td>
</tr>
<tr>
<td>1983</td>
<td>7.0</td>
<td>34.5</td>
</tr>
<tr>
<td>1984</td>
<td>6.1</td>
<td>30.0</td>
</tr>
<tr>
<td>1985</td>
<td>2.9</td>
<td>14.3</td>
</tr>
<tr>
<td>1986</td>
<td>3.8</td>
<td>18.7</td>
</tr>
<tr>
<td>Total</td>
<td>20.3</td>
<td>100.0</td>
</tr>
</tbody>
</table>


The table shows that foreign capital contribution was at a peak in 1983, but dropped sharply after 1984. Foreign investors complained of administrative problems and criticised some aspects of the law (Agwa, A., 1987, pp.4-8). Indeed, an official of the General Money Market Authority suggested in interview (22nd Jan., 1988) that the foreign capital contribution will completely disappear during the 1990s because of Egypt's escalating economic crisis.
However, foreign investment under this law is comparatively small and considerably lower than the Egyptian capital contribution because the impact of the companies law is limited for non-Egyptian investors.

3.3.1.3.2 Composition of Foreign Investment by Economic Sector

Table 3.6 reveals that the industrial sector contained the highest number of foreign enterprises operating under law 159 of 1981, followed by the services sector, while the agricultural sector took last place.

The industrial sector provided the largest amount of foreign capital, 53.3 per cent of the total, whilst the financial sector provided LE 3.9 million, though this represented a higher proportion of foreign capital than in other sectors. Finally, the agriculture sector received the smallest percentage of foreign investment, although the actual value was higher than that of the construction sector.

Table 3.6
Distribution by Sector of the foreign companies starting production up to 1986
Value in LE million

<table>
<thead>
<tr>
<th>Sector</th>
<th>No. of Companies</th>
<th>Total of Capital</th>
<th>Foreign Capital</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial</td>
<td>40</td>
<td>15.2</td>
<td>8.1</td>
<td>53.3</td>
</tr>
<tr>
<td>Services</td>
<td>39</td>
<td>10.2</td>
<td>4.4</td>
<td>43.1</td>
</tr>
<tr>
<td>Financial</td>
<td>22</td>
<td>6.1</td>
<td>3.9</td>
<td>63.9</td>
</tr>
<tr>
<td>Construction</td>
<td>18</td>
<td>3.6</td>
<td>1.5</td>
<td>41.7</td>
</tr>
<tr>
<td>Agricultural</td>
<td>17</td>
<td>11.4</td>
<td>2.4</td>
<td>21.1</td>
</tr>
<tr>
<td>Total</td>
<td>136</td>
<td>46.5</td>
<td>20.3</td>
<td>43.6</td>
</tr>
</tbody>
</table>

In general, the participation of foreign investment under law 159 is relatively modest and does not play such a crucial role in the development of the economy as was expected.

3.3.1.3.3 Ownership Structure of Foreign Companies Under Law No.159

Table 3.7, analyses foreign capital participation within each legal form of company under the Companies Law. The total number of joint ventures set up and starting production amounted to 136 companies with an authorised capital of L.E. 47.1 million and with a foreign capital share of LE 20.3 million, i.e. 43 per cent. In fact, out of those companies, 46 take the form of joint stock companies with an authorised capital of LE 35 million and with a

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Number of Companies</th>
<th>Joint Stock Companies</th>
<th>Limited Liability Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>Total Capital</td>
<td>Foreign Capital %</td>
</tr>
<tr>
<td>1982</td>
<td>6</td>
<td>1.9</td>
<td>0.5</td>
</tr>
<tr>
<td>1983</td>
<td>37</td>
<td>14.6</td>
<td>7.0</td>
</tr>
<tr>
<td>1984</td>
<td>31</td>
<td>15.1</td>
<td>6.1</td>
</tr>
<tr>
<td>1985</td>
<td>29</td>
<td>6.7</td>
<td>2.9</td>
</tr>
<tr>
<td>1986</td>
<td>33</td>
<td>8.8</td>
<td>3.8</td>
</tr>
<tr>
<td></td>
<td>136</td>
<td>47.1</td>
<td>20.3</td>
</tr>
</tbody>
</table>


foreign capital contribution of LE 12.2 million, i.e. 34.5 per cent of the total capital of this form and 25.5 per cent of the total capital of all companies. On the other hand, 90
companies are limited liability companies with an authorised capital of LE 11.7 million and with foreign capital contribution of LE 8.3 million (70.9 per cent of the total).

It can be seen from the table that the percentage foreign contribution is small in the shareholders companies as compared with the limited liability companies. This is in part due to the greater incentives given to the founders of this type of company, and in part to the preference of such investors for more closed projects.

3.3.2 Effect of Foreign Capital on Total Gross Investment

Based on the previous analysis, the distribution of foreign capital in total gross investment and its percentage is given in tables 3.8 and 3.9, which show that investment during the 1982/83-1986/87 planning period amounted to LE 34277.1 million, distributed among the public, private and foreign sectors, with 68.4, 26.2, and 5.4 per cent respectively.

The public sector contribution in total investment, 68.4 per cent, is relatively small compared with preceding years. For example, in 1974 the public sector was responsible for 94.1 per cent of all fixed investment, the private sector, including foreign capital accounting for the remainder. The rise in private sector investment, which reached 25.1 per cent during 1982/83-1986/84 (MEED, 1987, pp.50-56), reflects the opening of the economy to both foreign and private capital.

The allocation of the total fixed investment among
economic sectors reflected the government’s desire to stimulate the production sector and increase its share in total fixed investment (see tables 3.8 and 3.9).

Table 3.8
Gross Fixed Capital Formation by Sector and its Distribution Among Public, Private and Foreign Enterprises Up to the end of the Plan 1982/83-1986/87

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total Investment</th>
<th>Public Sector</th>
<th>Private Sector</th>
<th>Foreign Investment(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value (%)</td>
<td>Value (%)</td>
<td>Value (%)</td>
<td>Value (%)</td>
</tr>
<tr>
<td>Industry</td>
<td>11471.5 33.5</td>
<td>8818.9 37.5</td>
<td>2024.5 22.5</td>
<td>718.1 36.8</td>
</tr>
<tr>
<td>Agriculture</td>
<td>3329.7 9.7</td>
<td>2143.5 9.1</td>
<td>1186.2 13.2</td>
<td>70.4 3.8</td>
</tr>
<tr>
<td>Finance</td>
<td>8912.5 26.0</td>
<td>7827.8 33.3</td>
<td>575.9 6.4</td>
<td>508.9 27.5</td>
</tr>
<tr>
<td>Construction</td>
<td>5548.3 16.2</td>
<td>246.0 1.0</td>
<td>5145.9 57.2</td>
<td>79.2 4.2</td>
</tr>
<tr>
<td>Services</td>
<td>5015.1 14.6</td>
<td>4475.2 19.1</td>
<td>64.7 0.7</td>
<td>475.2 25.7</td>
</tr>
<tr>
<td>Total</td>
<td>34277.1 100.0</td>
<td>23511.4 100.0</td>
<td>8997.2 100.0</td>
<td>1851.8 100.0</td>
</tr>
</tbody>
</table>

Note: The Petroleum Sector is excluded from the analysis; investment in that sector is estimated at LE 5787.4 million distributed among public and private 1387.4, and 4400.0 million respectively.

Source: (1) Columns 1, 3, and 5 are compiled by the author from Ministry of Planning "The 1982-1986 Economic and Social Development Plan" Cairo, Dec., 1987, PP. 40-44.

(2) The foreign investment data are collected from General Authority for Investment and Free Zones, Money Market Authority, and The Directorate General of Foreign Currency, "Follow-Up Reports", various issues.

Table 3.9

<table>
<thead>
<tr>
<th>Sector</th>
<th>Public</th>
<th>Private</th>
<th>Foreign</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>25.7</td>
<td>5.9</td>
<td>2.1</td>
<td>33.7</td>
</tr>
<tr>
<td>Agriculture</td>
<td>6.2</td>
<td>3.4</td>
<td>0.2</td>
<td>9.8</td>
</tr>
<tr>
<td>Finance</td>
<td>22.8</td>
<td>1.7</td>
<td>1.5</td>
<td>26.0</td>
</tr>
<tr>
<td>Construction</td>
<td>0.7</td>
<td>15.0</td>
<td>0.2</td>
<td>15.9</td>
</tr>
<tr>
<td>Services</td>
<td>13.0</td>
<td>0.2</td>
<td>1.4</td>
<td>14.6</td>
</tr>
<tr>
<td>Total</td>
<td>68.4</td>
<td>26.2</td>
<td>5.4</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Table 3.8
Notes: The percentage calculated, for example, as follows: Public Sector percentage = 23511.4/34277.1 x 100
It can be concluded that foreign investment contributed to economic development in two significant ways. First, it paved the way for the implementation of the development plans. Second, it helped to achieve priority goals for investment and to speed up the rate of industrial growth. It may thus be that the acceleration of the growth rate was achieved only through the inflow of foreign investment capital and technology.

3.3.3 Effect of Foreign Investment On Employment

Table 3.10 indicates the changes in the number of employees and their wages and salaries within foreign enterprises operating in Egypt up to 1984, in order to measure to what extent these enterprises contributed to the creation of new jobs under the open door economic policy. The analysis concentrates upon the period up to 1984, due to the lack of detailed data relating to employment in foreign enterprises by sector after that date.

The first observation is that the absolute number of employees in foreign enterprises steadily increased over the three year period. For example, in 1983, the actual number of employees rose by 13.6% and their wages by 33.1%. In 1984, the number of workers increased by 30.6, and their wages by 56.7 per cent, reaching 110,025 employees with total wages amounting to LE 311.3 million.

Close analysis of the distribution of employment among the various sectors reveals a change in the rate of growth in both the size of the labour force and its wages. For
### Table 3.10
Development of Foreign Investment Employment by Sector and Year 1982/1984

<table>
<thead>
<tr>
<th>Sector</th>
<th>1982</th>
<th>1983</th>
<th>1984</th>
<th>Number</th>
<th>Wages</th>
<th>Number</th>
<th>Wages</th>
<th>Change %</th>
<th>Number</th>
<th>Wages</th>
<th>Change %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>34100</td>
<td>51.6</td>
<td>45685</td>
<td>94.8</td>
<td>28.1</td>
<td>83.7</td>
<td>51002</td>
<td>113.0</td>
<td>16.7</td>
<td>19.2</td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>4552</td>
<td>8.7</td>
<td>5296</td>
<td>6.9</td>
<td>14.3</td>
<td>(20.6)</td>
<td>7403</td>
<td>12.7</td>
<td>39.8</td>
<td>84.1</td>
<td></td>
</tr>
<tr>
<td>Construction</td>
<td>11346</td>
<td>21.6</td>
<td>12460</td>
<td>25.1</td>
<td>16.1</td>
<td>16.2</td>
<td>18158</td>
<td>41.5</td>
<td>45.4</td>
<td>63.3</td>
<td></td>
</tr>
<tr>
<td>Services</td>
<td>14550</td>
<td>34.9</td>
<td>11330</td>
<td>28.6</td>
<td>(21.6) (15.2)</td>
<td>18777</td>
<td>77.3</td>
<td>65.7</td>
<td>161.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Finance</td>
<td>9717</td>
<td>32.3</td>
<td>11433</td>
<td>42.2</td>
<td>17.7</td>
<td>30.6</td>
<td>14685</td>
<td>66.7</td>
<td>28.4</td>
<td>58.1</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>74165</td>
<td>145.1</td>
<td>84234</td>
<td>198.6</td>
<td>13.6</td>
<td>33.1</td>
<td>110025</td>
<td>311.2</td>
<td>30.6</td>
<td>56.7</td>
<td></td>
</tr>
</tbody>
</table>


Example: In 1983, the actual number of workers in the industrial sector rose by 28.1 and their wages by 83.7%, reaching 43,685 employees with total wages amounting to L.E 94.8 million. However, the growth rate in both number and wages significantly declined in 1984 as compared to 1983, although the absolute figures increased relatively from 43,685 workers and wages of L.E 94.8 millions, to 51,002 workers and wages of L.E 113.0 millions.

Moreover, it is noticeable from the same table that although the growth rate in both number and wages was small in the finance and services sectors compared with the industrial sector in 1983, it increased more than that of...
industrial sector in 1984. This is because of the change in the attitude of foreign investors towards the finance and services sectors which offered higher and faster capital return and other benefits than other sectors.

With regard to the relative importance of employment in foreign enterprises in relation to the total employment of all economic sectors, table 3.11 shows foreign projects' employment data:

### Table 3.11
The Relative Importance of The Foreign Investment Employment to total Employment by Sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>1982</th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value in LE million</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Number of employees in thousand</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A: Number</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industry</td>
<td>1548.0</td>
<td>34.1</td>
<td>2.2</td>
</tr>
<tr>
<td>Agriculture</td>
<td>4256.9</td>
<td>4.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Construction</td>
<td>656.7</td>
<td>11.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Services</td>
<td>2903.6</td>
<td>14.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Finance</td>
<td>1656.1</td>
<td>9.7</td>
<td>0.6</td>
</tr>
<tr>
<td>Total</td>
<td>11021.3</td>
<td>74.1</td>
<td>0.7</td>
</tr>
<tr>
<td>B: Wages</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industry</td>
<td>1462.7</td>
<td>51.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Agriculture</td>
<td>786.6</td>
<td>8.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Construction</td>
<td>381.5</td>
<td>21.6</td>
<td>5.7</td>
</tr>
<tr>
<td>Services</td>
<td>3106.3</td>
<td>34.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Finance</td>
<td>1236.6</td>
<td>32.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Total</td>
<td>6973.7</td>
<td>149.1</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source:—
contribution to the total employment in the economy from 1982-84.

It can be seen from the table that foreign projects accounted for only 0.7 and 2.1 per cent of the number of employees and their wages respectively at the end of 1982. Although their share increased to 0.8 per cent for employees and 3.7 for wages at the end of 1984, the greater part of this increase can be explained by the increasing number of foreign projects.

Close analysis of the contribution of foreign projects to total employment among the various sectors reveals a small share in both the size of the labour force and its wages. With regard to the size of labour force, the industrial sector holds first place, with foreign projects accounting for 2.2% in 1982, 2.7% in 1983, and 3.0% in 1984. Construction ranks in second place with 1.7% in 1982, 1.8% in 1983, and 2.4% in 1984. However, with regard to wages, it is the construction sector which holds first place, industry ranking second during the same period (see table 3.11). Foreign agricultural projects have made least contribution to both size of labour force and its wages.

To summarise, it can be said that, although government efforts to encourage foreign investment, the portion of their contribution to employment is still modest.

3.3.4 Contribution of Foreign Enterprises to National Production and Output (Value Added)

The aim of this section is to illustrate to what extent foreign enterprises contributed to both national production
and output. The 1982-1984 period has been used for analysis, because current data relating to this indicator is still unpublished and incomplete.

Table 3.12 reveals the changing share of foreign

<table>
<thead>
<tr>
<th>Table 3.12</th>
<th>Foreign Investment Production in relation to National Production by Economic Sectors (1982-1984)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Using 1981 prices as a base year</strong></td>
<td><strong>Value in LE Million</strong></td>
</tr>
<tr>
<td><strong>Sector</strong></td>
<td><strong>National Production</strong></td>
</tr>
<tr>
<td>Agriculture</td>
<td>5612.7</td>
</tr>
<tr>
<td>Industry</td>
<td>8777.7</td>
</tr>
<tr>
<td>Petroleum</td>
<td>3104.5</td>
</tr>
<tr>
<td>Electricity</td>
<td>244.2</td>
</tr>
<tr>
<td>Construction</td>
<td>2533.0</td>
</tr>
<tr>
<td><strong>Total Production Sector</strong></td>
<td>20308.1</td>
</tr>
<tr>
<td>Transport</td>
<td>1985.6</td>
</tr>
<tr>
<td>Suez Canal</td>
<td>669.3</td>
</tr>
<tr>
<td>Trade</td>
<td>4269.0</td>
</tr>
<tr>
<td>Finance</td>
<td>1417.5</td>
</tr>
<tr>
<td>Insurance</td>
<td>87.0</td>
</tr>
<tr>
<td>Tourism</td>
<td>496.1</td>
</tr>
<tr>
<td><strong>Total Services Sector</strong></td>
<td>8924.7</td>
</tr>
<tr>
<td>Housing</td>
<td>418.0</td>
</tr>
<tr>
<td>Public utilities</td>
<td>73.0</td>
</tr>
<tr>
<td>Social Services</td>
<td>997.7</td>
</tr>
<tr>
<td>Social Insurance</td>
<td>30.7</td>
</tr>
<tr>
<td>Government Services</td>
<td>4747.2</td>
</tr>
<tr>
<td><strong>Total Social Services Sector</strong></td>
<td>6266.6</td>
</tr>
<tr>
<td>Grand Total</td>
<td>35499.4</td>
</tr>
</tbody>
</table>

Source: (1) The first three columns are compiled from the Ministry of Planning. The 1982-1986 Economic and Social Development Plan Cairo, Dec., 1987, P.28
enterprises in national production during the period. If one looks at the absolute and percentage figures of the production of foreign enterprises distributed by sector, there is clear growth in each sector. In fact, the contribution of foreign projects in relation to national production increased from 6.5 per cent in 1982, to 7.5 per cent at the end of 1984. This means that their contribution to national production, although still modest, shows an increasing trend.

Reviewing the contribution to national production of each sector separately, we find that the financial sector recorded the highest percentage of the relative share for the whole period, followed by social services. On the other hand, a large share of total national production was directed towards the industrial, petroleum, and construction sectors respectively, but the relative contribution of these sectors fluctuated annually.

Tables 3.13 and 3.14 indicate the net contribution of foreign investment output to gross national output, while table 3.13 shows the rate of net value added to the output of these enterprises. The most reliable figures available are those published by the Ministry of Planning, the General Authority for Investment, and the Money Market Authority. In order to measure the value added, the form used by the uniform accounting system is adopted, as shown in figure 3.2 below.

Based on this form, table 3.13 has been prepared after subtracting raw material costs and services acquired from
Figure 3.2

Value added statement for the period

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production at Selling Price</td>
<td>xx</td>
</tr>
<tr>
<td>Less: The Purchase Cost of Finished Goods Purchased for Sale</td>
<td>xx</td>
</tr>
<tr>
<td>Value of production and Services at selling Price</td>
<td>xx</td>
</tr>
<tr>
<td>Add: Subsidies</td>
<td>xx</td>
</tr>
<tr>
<td>Less: Customs Duties</td>
<td>xx</td>
</tr>
<tr>
<td>Other Taxes (such as stamps, rates, and vehicle road tax)</td>
<td>xx</td>
</tr>
<tr>
<td>Value of Production and Services at cost of factors of production</td>
<td>xx</td>
</tr>
<tr>
<td>Less: Commodity Requirement</td>
<td>xx</td>
</tr>
<tr>
<td>Services Acquired</td>
<td>xx</td>
</tr>
<tr>
<td>Gross Value Added (output)</td>
<td>xx</td>
</tr>
<tr>
<td>Less: Depreciation</td>
<td>xx</td>
</tr>
<tr>
<td>Net Value Added (at cost of factors of production)</td>
<td>xx</td>
</tr>
</tbody>
</table>


Note: Commodity Requirement refers to the raw materials needed by the company for production.
production at factor cost, to arrive at the figure for gross value added, and depreciation is subtracted from gross value added to arrive at net value added.

Table 3.13
Foreign Investment Output, Net Value Added and Net Value Added as indicators (percentages) 1982-1984

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial</td>
<td>54.8</td>
<td>29.6</td>
<td>135.0</td>
<td>353.7</td>
<td>29.6</td>
<td>353.7</td>
<td>113.4</td>
<td>28.7</td>
<td>289.7</td>
</tr>
<tr>
<td>Agricultural</td>
<td>19.4</td>
<td>10.5</td>
<td>39.5</td>
<td>72.9</td>
<td>9.4</td>
<td>72.9</td>
<td>16.2</td>
<td>11.7</td>
<td>32.6</td>
</tr>
<tr>
<td>Construction</td>
<td>11.6</td>
<td>6.3</td>
<td>41.2</td>
<td>91.9</td>
<td>9.0</td>
<td>91.9</td>
<td>9.8</td>
<td>6.7</td>
<td>30.2</td>
</tr>
<tr>
<td>Financial</td>
<td>75.4</td>
<td>40.9</td>
<td>215.3</td>
<td>374.8</td>
<td>55.8</td>
<td>374.8</td>
<td>55.8</td>
<td>52.6</td>
<td>348.2</td>
</tr>
<tr>
<td>Services</td>
<td>23.5</td>
<td>12.7</td>
<td>28.6</td>
<td>45.8</td>
<td>4.2</td>
<td>45.8</td>
<td>4.2</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Total</td>
<td>185.1</td>
<td>100.0</td>
<td>459.4</td>
<td>937.1</td>
<td>100.0</td>
<td>937.1</td>
<td>100.0</td>
<td>100.0</td>
<td>771.2</td>
</tr>
</tbody>
</table>


As table 3.13 indicates, foreign investment projects have generally achieved a high net value added, amounting to more than 70 per cent of their output during the period under review. This is because foreign projects recorded a high growth rate in output, amounting to more than double during the period. The figures for their output also recorded an increased share in national output, rising from 1.7 per cent in 1982 to 8.0 per cent in 1984 (see table 3.14).
For a comparison of value added to production of these projects, table 3.15 reveals that percentage gross value added increased from 7.9 per cent in 1982 to 29.5 per cent in 1984. These percentages of value added seem modest. The main reason behind this is that the cost of raw materials used by foreign enterprises in their production is very high (see Squibb Egypt case study in part III as an example) and this is reflected in the decrease of net value added. Therefore, it can be said that an increase of value added can account for the entire increase in production.

Turning back to table 3.13, it can be seen that the output from foreign investment rose steeply, starting from LE 185.1 million in 1982 to LE 937.1 million in 1984. The table shows also that the net value added followed the same trend, rising from LE 138.6 million in 1982 (i.e. 74.8 per cent of the output) to LE 394.6 million (85.9 per cent of output) in 1983. In 1984, the amount of net value added again increased to LE 777.1 million, but its ratio to output declined by three percent. This decline was attributable to the production capacity which became idle over this period, the lack of labour productivity, and the use of more imported raw materials (Central Agency for Auditing, 1987). Moreover, over the period considered, capital employed by foreign enterprises rose at a much faster rate than labour employed. This implies that production techniques relied more on capital than labour (Ibid).

As regards the ratio of the net value added to output in the various sectors, the highest ratio was that of the
Table 3.14

Foreign Investment Output to Gross National Product (percentage)1982-1984

<table>
<thead>
<tr>
<th>Sector</th>
<th>1982</th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
<td>1.8</td>
<td>4.1</td>
<td>9.8</td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.4</td>
<td>0.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Construction</td>
<td>0.7</td>
<td>2.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Finance</td>
<td>5.0</td>
<td>14.2</td>
<td>22.1</td>
</tr>
<tr>
<td>Services</td>
<td>0.8</td>
<td>0.9</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1.7</td>
<td>4.5</td>
<td>8.0</td>
</tr>
</tbody>
</table>


Table 3.15

Development in Gross Value Added in Relation to Production (ex-factory prices) in Foreign Investment Projects

<table>
<thead>
<tr>
<th>Year</th>
<th>1982</th>
<th>1983</th>
<th>1984</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Value Added</td>
<td>185.1</td>
<td>459.4</td>
<td>937.1</td>
</tr>
<tr>
<td>Production (ex-factory)</td>
<td>2331.6</td>
<td>2805.5</td>
<td>3170.6</td>
</tr>
<tr>
<td>% GVA to Production</td>
<td>7.9</td>
<td>16.4</td>
<td>29.5</td>
</tr>
</tbody>
</table>


Finance sector, amounting to 73.6% in 1982, 93.8% in 1983, and 92.9% in 1984. The average percentage of this sector is about 88.7% for the whole three-year period. Agriculture holds the second place, accounting for 83.5% in 1982, 84.7% in 1983, and 79.3% in 1984, and the industrial sector ranks the third, with 70.2% in 1982, 83.5% in 1983, and 81.9% in
1984. The average percentage is about 88.5% and 82.5% for the agriculture and industrial sectors respectively. This reflects the weight of foreign projects in economic development under the open door policy.

Finally, with regard to the contribution of foreign investment in economic development, table 3.16 shows the changes which have occurred since the adoption of the open door economic policy. Foreign investment was relatively modest compared with gross national product, particularly at the beginning of the period. However, the amount of foreign investment in absolute terms and as a percentage of gross domestic output increased sharply from LE 39.0 million, i.e. 0.9 per cent, in 1974, to LE 296.0 million, i.e. 3.2 per cent, in 1978, and to over 7.0 per cent in 1979. During 1982-1984 the ratios increased by 7.3 per cent on average. In the late 1970s and early 1980s, the government began to encourage foreign investors, especially those from high-income countries, to form joint ventures with local capital, and increase the ratio of local value added to output. This policy was successful in 1982 in attracting more major MNE's from the United states, Europe, and Japan.
### Table 3.16

Foreign Investment and its ratio to Gross Domestic Product (1974-1984)

<table>
<thead>
<tr>
<th>Year</th>
<th>(GDP) Factor Current prices</th>
<th>Foreign Investment Value in LE million</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>4199.6</td>
<td>39.0</td>
<td>0.9</td>
</tr>
<tr>
<td>1975</td>
<td>5061.3</td>
<td>105.0</td>
<td>2.1</td>
</tr>
<tr>
<td>1976</td>
<td>6164.2</td>
<td>181.0</td>
<td>2.9</td>
</tr>
<tr>
<td>1977</td>
<td>7399.9</td>
<td>266.0</td>
<td>3.4</td>
</tr>
<tr>
<td>1978</td>
<td>9013.2</td>
<td>296.0</td>
<td>3.2</td>
</tr>
<tr>
<td>1979</td>
<td>12077.7</td>
<td>867.5</td>
<td>7.1</td>
</tr>
<tr>
<td>1980</td>
<td>15808.3</td>
<td>975.0</td>
<td>6.1</td>
</tr>
<tr>
<td>1981</td>
<td>20097.0</td>
<td>1045.0</td>
<td>5.2</td>
</tr>
<tr>
<td>1982</td>
<td>22091.1</td>
<td>1735.0</td>
<td>7.9</td>
</tr>
<tr>
<td>1983</td>
<td>23848.1</td>
<td>1747.0</td>
<td>7.3</td>
</tr>
<tr>
<td>1984</td>
<td>25610.2</td>
<td>1752.4</td>
<td>6.8</td>
</tr>
</tbody>
</table>


To summarise, it can be said that, despite government efforts to encourage foreign investment, the contribution in this field was still meagre.

#### 3.3.5 Effects of Foreign Enterprises on the Balance of Payments

One of the standard arguments in support of foreign investment projects in Egypt is that they increase the export capacity of the Egyptian economy and thus lead to gains in tax and foreign exchange earnings. However, the data available on the performance of foreign investment...
enterprises, suggests that they had a detrimental influence on the balance of payments (Central Agency for Auditing, 1987, p.231).

The main reason for this was that their export and import activities increased the deficit on the current account in the balance of payments.

Other reasons were the lack of planning and control for import/export efficiency, (Ibid) the overvaluation of the real rate of foreign exchange which served to encourage imports and discourage exports, and the length of the tax exemption period. Finally, the flow of capital and profits abroad represented a drain on foreign exchange reserves. For example, the total of payments of dividends on capital, service fees, royalties, and interest on loans amounted to LE 180.1 million in 1980, increasing to LE 208.5, and 316.7 million during 1983 and 1984 respectively (Ibid).

3.3.5.1 Export and import performance

The data concerning exports and imports for the 1981-1984 period in table 3.17, reveal that all exports of goods and services accounted for an average of 4.6 per cent of the total national exports over the period considered. The activities of these enterprises also resulted in a L.E. 495.4 million increase in the current account deficit over the same period. The average ratio of actual exports to planned exports is clarified in the notes under table 3.17.

The planned export rate according to the feasibility studies of the projects was 24 per cent of sales, while the
<table>
<thead>
<tr>
<th>Sector</th>
<th>Actual Exports</th>
<th>Actual Imports</th>
<th>Balance of Trade Deficit</th>
<th>National Exports (Actual)</th>
<th>% Relative Importance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goods</td>
<td>13.0</td>
<td>174.0</td>
<td>161.0</td>
<td>850.5</td>
<td>1.5</td>
</tr>
<tr>
<td></td>
<td>17.0</td>
<td>303.0</td>
<td>286.0</td>
<td>823.6</td>
<td>2.1</td>
</tr>
<tr>
<td></td>
<td>14.1</td>
<td>378.0</td>
<td>363.9</td>
<td>1063.1</td>
<td>1.3</td>
</tr>
<tr>
<td></td>
<td>32.3</td>
<td>405.6</td>
<td>373.3</td>
<td>993.9</td>
<td>3.2</td>
</tr>
<tr>
<td>Services</td>
<td>6.0</td>
<td>198.3</td>
<td>192.3</td>
<td>325.5</td>
<td>1.8</td>
</tr>
<tr>
<td></td>
<td>15.0</td>
<td>248.4</td>
<td>233.4</td>
<td>251.8</td>
<td>5.9</td>
</tr>
<tr>
<td></td>
<td>36.8</td>
<td>216.3</td>
<td>179.5</td>
<td>238.4</td>
<td>15.4</td>
</tr>
<tr>
<td></td>
<td>17.5</td>
<td>209.5</td>
<td>192.0</td>
<td>339.7</td>
<td>5.2</td>
</tr>
</tbody>
</table>

Source: (1) Columns 1 and 2 were compiled from Central Agency for Auditing, "Appraisal of Foreign Investment Up to 1984" Op. Cit., and General Authority for Investment, "Foreign Investment Follow Up Reports" Op. Cit.,
(2) Column 4 was collected from Ministry of Planning, "The 1982-1986 Economic and Social Development Plan" Op. Cit.,

Note: The actual exports of foreign enterprises' represent on average 2.7% of the total planned exports over the period under review, Central Agency for Auditing, "Appraisal of Foreign Investment up to 1984" Op. Cit.,

actual ratio of exports to sales was only 1.8 per cent. Although the figures of exports have steadily increased in absolute terms over the period of study, their actual percentage in relation to sales was only 2.7 per cent in 1984. This reflects the lack of government monitoring and control, causing a shortfall in the ratio of exports to
sales of roughly 88.8 per cent (Ibid).

The net effect of these exports and imports on the balance of payments is estimated by comparing actual exports by foreign enterprises with their actual imports. The results showed that Goods and Services imports totalled LE 372.3 millions in 1981, while their export earnings were only LE 19.0 million (see table 3.17). In 1982, the value of imports by these enterprises increased to LE 551.4 millions, whilst export earnings reached only LE 32 millions.

Accordingly, the balance of trade deficit jumped from LE 353.3 millions in 1981, reaching LE 519.4 million in 1982. In 1984, the value of imports reached LE 611.1 millions, while exports amounted to only LE 49.8 millions, producing another sizeable increase in the balance of trade deficit, to LE 565.3 million.

It is evident that the environment has not been conducive to export activity by foreign enterprises, and the country missed out completely on the wave of export-oriented investment that went to several developing countries in South-East Asia.

As for the contribution of foreign investment enterprises to total exports, table 3.17 shows that it accounted for 1.5 per cent for goods and 1.8 per cent for services in 1981, increasing to 2.1 and 5.9 per cent in 1982. In 1984, the contribution of goods increased to 3.2 per cent of the total, whilst the services ratio declined to 5.2 per cent. This weakness was attributed to a number of factors, among them, the lack of government control and
failure to adopt a clear policy towards exports. Other factors were the lack of a system of protection, pricing policy, and the unconditional incentives given to these projects.

Over the four year period considered there was thus a continued discrepancy between the value of imports of intermediate goods and services, and annual proceeds from exports, reflected in the increased balance of payments deficit. If not controlled this imbalance will continue to affect adversely the balance of payments in the foreseeable future.

3.3.5.2 Taxation

Egypt has both direct and indirect taxation. The level of direct taxation varies according to the level of income, and to its origin. Indirect taxation is broadly based and designed to guide purchasing power in the desired direction. Direct tax is exacted on agricultural land and buildings, income from business, including profits from industrial and commercial ventures and profits from capital, and income from wages, salaries and professional fees. Indirect taxation is mainly in the form of customs duties, stamp duties, and consumption taxes.

Tax receipts account for a substantial proportion of government revenue. Therefore, the contribution of foreign investment enterprises should be viewed in terms of the country's total tax receipts. Nevertheless, it should be remembered that tax incentives have been given to foreign
investors by various investment laws, which might cause a negative influence on tax receipts and the balance of payments position simultaneously. The fact is that, after the end of the tax holiday periods, the great majority of these enterprises evade taxation by such techniques as transfer pricing, royalties and services fees, and submit tax returns reflecting losses or minimal profits. This is evidenced by the very low level of tax receipts from these enterprises shown in table 3.18.

It is clear that the lack of legislation to prevent tax evasion, together with the tax incentives offered resulted in no substantial tax accruing to the state from foreign enterprises, and particularly those of the big MNEs. Evidence of this is provided by table 3.18, which shows the level of tax receipts from foreign enterprises operating in Egypt over the period 1980/81 to 1986/87. In these seven years, the net contribution of foreign enterprises to the state in the form of direct and indirect taxes totalled, on average, around three per cent of all taxes paid in the state. However, during that time the absolute figures for both types of tax, and their percentages, steadily increased until 1984/1985, reaching LE 317.2 millions, i.e. 4.6 per cent of total tax receipts. In the next two years, tax receipts again declined to reach LE 269.5 million, i.e. 3.5 per cent.

The declining proportion of tax receipts from these enterprises would seem to result from the ineffective
Table 3.18

Tax Receipts from Foreign Enterprises (1981-1987)

Value in LE million

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Tax Receipts of the Country</th>
<th>Total Tax Receipt from Foreign Projects</th>
<th>% relative importance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980/81</td>
<td>4181.0</td>
<td>48.2</td>
<td>1.1</td>
</tr>
<tr>
<td>1981/82</td>
<td>5479.7</td>
<td>59.2</td>
<td>1.1</td>
</tr>
<tr>
<td>1982/83</td>
<td>5923.5</td>
<td>156.6</td>
<td>2.6</td>
</tr>
<tr>
<td>1983/84</td>
<td>6148.1</td>
<td>219.9</td>
<td>3.6</td>
</tr>
<tr>
<td>1984/85</td>
<td>6966.9</td>
<td>317.2</td>
<td>4.6</td>
</tr>
<tr>
<td>1985/86</td>
<td>7593.6</td>
<td>269.5</td>
<td>3.5</td>
</tr>
<tr>
<td>1986/87</td>
<td>7909.7</td>
<td>273.7</td>
<td>3.5</td>
</tr>
</tbody>
</table>


tax system, and the additional financial and economic incentives which Egypt has offered to foreign investors since 1985/86. Finally, there has been no effective control to prevent artificial transfer pricing in intra-company transactions, adjustments in royalties and services, and arbitrary allocation of administrative costs, which can be used to minimise the tax burden.

It seems clear from the above analysis that the implementation of the new open door economic policy has been associated with a general atmosphere of tax evasion with a detrimental impact on tax receipts.

All in all, the limited tax regulation and lack of effective control of the income of foreign enterprises under the open door economic policy, coupled with serious administrative corruption and enforcement difficulties,
suggest that the Egyptian tax system is inadequate in terms of its control capacity.

3.7 Conclusions

This chapter has provided a historical review of foreign investment policies before and after 1973, and has shown the actual contribution of the foreign investment to the economy in terms of gross investment, employment, national output and balance of payments. Over the period 1982-1986, the rate of growth of foreign investment in Egypt increased to more than double the level in the 1970's, although the value of investment was still modest, as compared with domestic investment, and was accompanied by sectoral fluctuations. This means that, in general, the flow of direct investment has had a noticeable impact on the economic structure, and that, given the right conditions, it could play a crucial role in the Egyptian economy in favour of high technology activities, as envisaged by the five-year plan. However, it should be stressed that the great majority of foreign enterprises prefer to invest in such activities as finance, tourism, and services rather than in manufacturing and agriculture, which are still the mainstay of Egypt’s economic prosperity.

By 1984, foreign enterprises had increased their share of national output in constant prices by 8 per cent in comparison to less than 3 per cent in 1974. In addition, about 7 per cent of national production, on average, was controlled by foreign foreign enterprises over the period
under review, and this contribution in some activities was steadily increasing.

The rate of increase in foreign investment might suggest that there is cause for concern at the growing influence of foreign enterprises in the economy, even though the extent of foreign penetration is not as great as in other developing countries such as Hong Kong, Singapore, etc. (Dunning, J., 1985). Egypt’s advantages include the stability of its government, a stable business and social environment, a large domestic market, the largest pool of trained labour in the Arab World, and a strategic location with preferential trade access to the Middle East, Europe, and African markets.

The contribution of foreign enterprises to employment has been relatively modest, particularly in the short term. However, foreign enterprises have a high and increasing proportion of salaried employees in the area of technological development, and their main impact has been in the skilled and semi-skilled area, while purely national enterprises, in particular in the public sector, employ a high proportion of both semi-skilled and unskilled labour.

In respect of the balance of payments position, Egypt has in recent years become economically more vulnerable as a result of the unfavourable impact of MNE’s transactions. The earlier results proved that the export value of foreign enterprises was far below that of their imports. This is attributed to several factors such as trade barriers, the
change in relative production costs, the repeated changes in foreign exchange rates, and administrative problems. In addition, it is evident from the analysis that foreign enterprises seek to minimise their tax burden by transfer pricing and their exchange losses by currency hedging and leading and lagging payments.

One result has been an escalation of inflation. By 1985, consumer prices were rising (even with many key consumer items price-controlled) at an annual rate of over 13 per cent, increasing to 22.5, and 25.1 per cent in 1986 and 1987 respectively, as compared to 3 per cent in 1971 (CBE, 1987, p.231). Another observation is that much of the expansion of foreign investment has been financed from Egyptian sources, e.g. loans from domestic banks and finance companies, making their capital contribution to the Egyptian economy rather less impressive than expected.

In short, it can be concluded that foreign investment is expected to grow and to play a crucial role in the economic development process of Egypt. Since the government perceives itself as directly responsible for the securing of national objectives, the question arises, what techniques does or should the government use at entry and during operation to exercise control over foreign enterprises?
Chapter IV

Egyptian Government Control
Over Foreign Enterprises

4.1 Introduction

This chapter outlines the control process currently operated by the government at the entry and operational stages over foreign enterprises in Egypt. Entry control is the process by which the government decides upon the acceptability of a foreign proposal. Operational control is the process by which the government evaluates the enterprise's performance and determines the amount of profit to be transferred to the parent company. The line between the two processes cannot be easily drawn, however, as the operations of a foreign enterprise are basically subject to the process applied at entry. The purpose of this chapter therefore is to identify the process, explain how it operates, evaluate its effectiveness, and indicate what changes are required to enable the process better to meet both national objectives and those of foreign enterprises.

In the light of the above, the chapter will be divided into four main sections as follows:

1. Criteria of the control process;
2. Structure of government control;
3. Entry control;
4. Operational control.

4.2 Criteria of the Control Process

Based on the country's objectives introduced in the October Paper and in the code of foreign investment (see
chapter 3), several measurement criteria are applied in evaluating any foreign investment proposal at the entry and operational stages. It emerged from interviews with the officials in GAFI, GCA and CMA who are responsible for monitoring foreign investment that the feasibility study of a proposed project should be examined from financial, economic and technical points of view.

4.2.1 Financial Criteria

It was asserted during interviews that the feasibility study of a new project should be assessed in terms of the project's ability to make profit and meet its obligations through an appropriate financial structure. The adoption of these criteria helps the government to decide on the acceptability of a proposed project.

GAFI and GCA usually use the rate of return on equity and/or rate of return on invested capital to measure a project's profitability. In interview, it was explained that the government authorities, especially the GAFI, have from experience developed some norms to be used in judging the project's profitability. These norms, which are mainly the rates of return on equity and invested capital, differ from one project to another according to economic sector as follows:

(1) Industry sector from 15% to 30%
(2) Pharmaceutical sector from 12% to 30%
(3) Services sector from 20% to 30%
(4) Agriculture sector from 0% to 7%
With regard to the second financial measure, GAFI, GCA and CMA usually use the debt ratio as a financial criterion to measure the ability of a proposed project to meet its obligations, and cash flow analysis based on Forecasted Cash Flow to measure the project’s ability to generate cash. The norm of debt ratio applied varies from one project to another according to the investment costs of the project. GAFI makes the following distinction:

(1) Projects with investment costs of L.E. 5 million (or less): the debt ratio should be 1:1, i.e. equity capital should be at least 50% of the total costs.

(2) Projects with investment costs of more than L.E. 5 million: the equity capital should be not less than 35% of the total costs.

4.2.2 Economic Criteria

During an interview with officials at GAFI and GCA, it was explained that the expected effect of the proposed project on the sector concerned and the economy as a whole should be examined in terms of value added, employment, balance of payments, and transfer of technology.

To evaluate the project’s effect on national income, the government uses net value added to measure the income generated to the production factors. The value added consists of the amount paid to the four factors of production (i.e. labour, land, entrepreneur, and capital). The following equation is used to calculate the expected net value added:

\[ \text{Net Value Added} = O - [ I + D ] \]
Where,

\[ O = \text{total value of output of the project} \]
\[ I = \text{total value of input consisting of materials, utilities, and supplies.} \]
\[ D = \text{depreciation of fixed capital} \]

During an interview at the GFIA, it was stated that a project cannot be accepted unless it will make a positive contribution to the national income. However, the code of foreign investment does not specify the level of contribution expected from a project.

With regard to the employment criterion, the government stipulates that, in order for a project to be approved it should provide jobs for Egyptian employees and train them to acquire new skills. Egyptians should constitute not less than 80% of the project’s total employment and their remuneration should be at least 70% of the total wages and salaries.

As for the effect on the balance of payments, the government use the net foreign exchange earned and saved by the project as measurement criterion.

The inflow of foreign exchange comes from equity and loans in foreign currency, export receipts, foreign currency saving due to import substitution, and other foreign currency receipts. The outflow of foreign exchange consists of imported capital equipment and raw materials and intermediate goods, expatriate salaries, loan repayment and interest, capital repatriation and profit remitted, royalties and management fees, initial expenses and construction requirements paid in foreign currency and the
There are thus two main criteria, i.e. financial and economic, by which the feasibility study of a foreign project is evaluated and approval given at entry, or evaluation carried out at the follow-up stage. However, the criteria as currently operated have some shortcomings which significantly reduce their effectiveness in helping the government to make the appropriate decision:

1. When government officials use these criteria to judge the acceptability of a proposed project, they do not have an order of priority. For example, GAFI may have to choose between project X which can contribute L.E. 400,000 to national income and offer 400 jobs, and project Y which will contribute L.E. 650,000 to national income and provide 200 jobs. Which project should the government approve? This question has no answer in the existing criteria. The lack of an order of priority is particularly felt when government officials decide upon the acceptability of an investment proposal which contributes positively to one aspect of the national objectives (e.g. value added) but has a negative impact on another (e.g. balance of payments).

2. The criteria are vaguely defined. For example, if a project should make a positive contribution to foreign exchange, what is the minimum sum of foreign currency which the project should contribute in order to be accepted? This question is not answered in the system currently operated. Also the government stipulate that an approved project
should train Egyptian employees to acquire new skills. When and how are the skills to be considered? This question also is not answered.

3. In addition to the above shortcomings, the value added criterion is inadequate, due partly to the disregard of foreign transformation, and partly to the charge of local raw materials to value added.

4.3 The Structure of Egyptian Governmental Control

In order to understand how Egyptian government control is applied to foreign enterprises operating in Egypt it is necessary to investigate the functions of each department and agency concerned.

A number of bodies are involved in the supervision of these enterprises. Among these is the General Authority for Foreign Investment, which is the only agency with general responsibility for regulating and following up the activities of foreign investments. Other supervising agencies are involved in specific areas, e.g. the General Companies Administration, the Tax Administration and departments such as Organisation of Drugs in the Health Ministry and General Authority for Manufacturing in the Industry Ministry. The roles of these departments and agencies in the control process will be reviewed below.

4.3.1 General Authority for Investment and Free Zones

Article No. 11 of Law No. 65 of 1971 established a government organisation, "The general organisation for Arab capital and free zones", whose main responsibility was to
examine applications from foreign investors, for approval or rejection.

In 1974, the organisation was restructured in accordance with Law 43 for foreign investment. Since then, it has become an independent legal authority with the name, "The General Authority for Arab and Foreign Investment and Free Zones". The Authority is under the Minister of Economy and Foreign Trade, who is the Chairman of the Board of Directors. A Deputy Chairman is appointed by presidential decree, the president being its managing director, presiding over the executive bodies of the Authority. The organisational structure consists of nine linked divisions as follows:

1. The Deputy Chairman of the Board of Directors of the Authority, and the office of administrative and technical staff.
2. Industrial projects division.
3. Agriculture and construction projects division.
4. Financial and services projects division.
5. Free zones division.
6. Information and research division.
7. Follow Up and Auditing division.
8. Legal division.
9. Investors relations division.

The functions of the authority could generally be divided into three areas (Articles No. 25, 26 of Law 34 of 1974). The first is to recommend and implement a general
policy, guiding potential investors during the application stage and advising on the procedural requirements for project approval.

The second area is concerned with the overall appraisal of new projects. Feasibility studies for proposed projects are studied and a report submitted, within two months, to the Board of Directors (Joint Committee) giving the opinion of the experts to whom the study has been referred. Final approval of projects is given by the Board of Directors, which contains 20 members: the Deputy Prime Minister of Economic Affairs, the relevant Ministers, the Deputy Chairman of the Board of Directors, the Chairman of the General Money Market Authority, the Central Bank Chairman, and various experts.

The third area is that of control, follow-up and performance evaluation. In this context, the Follow-up and Auditing Division is responsible for conducting a financial examination of the project in the light of its feasibility study and budgets in order to protect the country's interests. It approves remittances outside the country, registers incoming capital, and follows-up the movement of capital and current account of the project in foreign currency. The Investment Authority is the only government agency dealing with foreign investors and occupies a central position in the government's economic planning and regulation machinery. Its control over project feasibility studies affects enterprises directly, whilst its control of their activities significantly affects economic development.
4.3.2 General Companies Administration

The Administration, supervised by the Minister of Economy and Foreign Trade, is run by a Chairman nominated by presidential decree. Its representatives attend the general assemblies of enterprises, follow-up dividend distribution of enterprises which have shares through public subscription, and ensures that meetings are properly conducted.

Financial reports of foreign enterprises, supported by additional documentary evidence, must be submitted every year to the administration to ensure that the subsidiary's operations are in accordance with the budget and the country's objectives and regulations. The administration may ask for such explanation or documents as it deems necessary (Article No. 315 of Executive Regulation of Law 159 of 1981).

4.3.3 General Directorate for Foreign Currency

The General Directorate for Foreign Currency, supervised by the Minister of Economy and Foreign Trade, is run by a Chairman nominated by presidential decree. The organisational structure of this directorate consists of five departments. One of these is the Foreign Investment Department which is responsible for following up and evaluating foreign enterprises operating under Law 156 of 1953. Its main function is to examine the annual financial reports once they have been submitted and approve the transfer of funds (e.g. profit remittance, royalties,
4.3.4 Capital Market Authority

In 1979, the Capital Market Authority was established to develop and promote the capital market. Since then, the main function of the Authority has been to regulate and follow up the establishment of companies whose shares are offered to the public. Participation in the capital of these companies is usually evaluated at the time of their registration and during operation, by examining financial documents and scrutinising the production process. At the issue stage, a group of Authority experts inspects the company documents, and may impose penalties if any violations of law are discovered. After the issue, the Financial Analysis Department of the Authority examines the annual financial reports of companies registered on the stock exchange list which being made available to the users.

The Authority is also carrying out a broad study with a view to adopting a computerised communication system, which would make instantly available information on transactions effected in the Cairo and Alexandria stock exchanges, through electronic terminals at the Authority, banks and stock exchanges abroad (Fag El Nour, M., 1986). However, this study has so far not been finished and is still under consideration.

4.3.5 Tax Administration

Taxation is a major source of a country's revenue, and foreign enterprises are among the major taxpayers. Therefore, in the light of the foreign investment code, a
new tax office, the Arab and Foreign Funds Investment Tax District Office has been set up to apply the tax and foreign investment laws.

Each foreign enterprise must submit to the tax district office its feasibility study, including the starting date of the operation. Subsequently, it must submit an annual declaration accompanied by statistics, approved by the account censor. The tax officer, in the normal course of his professional duties, should be in a position to observe whether the enterprise's transactions are recorded in a satisfactory manner. However, most tax officials have little experience in dealing with the problems arising between the administration and enterprises, (for example in relation to foreign exchange rate fluctuations, depreciation, royalties) and there is a lack of co-ordination between the tax administration and the foreign investment authority in decision making.

In 1987, the government took steps towards improving the relationship between government agencies and foreign enterprises, by creating a joint committee to sort out these administrative problems.

4.3.6 The Relevant Ministry

The relevant Ministry (e.g. Health Ministry, Tourist Ministry, or Industry Ministry) is responsible for following up the operations of approved projects in terms of production and/or services produced, employment etc.

To carry out this responsibility, permanent
organisations have been established, such as the General Authority for Manufacturing and General Organisation for Drugs, headed by their Ministers and including representatives from other ministries.

These agencies supervise imports, with special attention to prices and quality, domestic production and the distribution of this production. For example, the main function of the General Organisation for Drugs is to take full responsibility for planning and control of the pharmaceutical industry. Its duties are classified into three groups:

(1) planning and following-up of production;
(2) pricing and quality control, and
(3) imports and distribution.

The Follow-up and Planning Department at this organisation must determine future demand in the various therapeutic categories, and assess the production capacity of the domestic industry. The Organisation studies the production plans of the enterprises and investigates foreign sources of prospective imports.

The department also establishes a pricing policy for foreign and local drugs, and follows up enterprise plans, measuring each enterprise's expected budget in order to ensure their growth and that of the industry itself.

The quality control department is responsible for ensuring that product quality standards are maintained in manufacturing establishments. The penalty for unsatisfactory production standards is withdrawal of a
laboratory's licence (GOD, 1980). Another important task is to set up systems for accelerating production techniques and, in particular, reducing wastage.

Regarding exports and imports, a department has been established to organise these, in order to enable foreign enterprises to compete in the international market. Distribution is another responsibility of the organisation. The department of distribution is in charge of the distribution of drugs needed by all chemists for consumer requirements.

Thus, government agencies apply a relatively high level of control over foreign investment in the pharmaceutical industry. The activities of Squibb Egypt should be controlled and monitored by these techniques as seen later in part III.

The role of the General Authority for Foreign Investment would be to control the entry and operation of Squibb Egypt, using the foreign investment rules and regulations to meet the country's need for drugs, job creation, foreign exchange earning, etc. The Egyptian tax system provides the tax administration with the policies and techniques needed to assess the accounts of Squibb Egypt, in order to see that the country's financial and economic objectives are met.

As for the final organisation of control, it will be seen that the Organisation of Drugs, in its present form, is the only government agency, headed by the Minister of
Health, responsible for overseeing and managing the pharmaceutical sector. The Organisation's duty is to guide and harmonise the operation of all enterprises under its control, whether public or private, by approving their annual production and investment plans. This approval is usually given without much alteration, because there is a high degree of consultation and co-ordination between the planning department of the Organisation and the enterprises. The examination and assessment of proposed foreign projects requires well-established techniques, which combine clarity with simplicity, ensuring that these projects are consistent with the country's objectives.

In the light of the above considerations, one can conclude that each organisation involved in the system of control over foreign enterprises' activities is responsible for the application of one or more techniques. The investment authority is responsible for carrying out both financial, and managerial control techniques in order to follow up and evaluate actual progress. The tax administration is responsible for applying both legal and financial control on the collection of tax. The General Companies Administration exercises managerial control over the level of employment and wages. Finally, the appropriate agency carries out managerial control of prices and the size and quality of production.

4.4 Entry Control System

As seen earlier, entry control refers to the process by
which the government decides on the acceptability of the proposed project. This section therefore outlines this process as currently operated by the Egyptian government, under two headings: entry requirements and investment application and evaluation.

4.4.1 Entry Requirements

The Foreign Investment Code and Law No. 159 of 1981 set out a list of entry conditions which must be met for a foreign investment proposal to be accepted. These conditions are concerned with strategic activities, ownership and invested capital.

4.4.1.1 Strategic Activities

Foreign enterprises are allowed to set up business activities within the framework of the State’s policy and based on the annual national economic plan. Accordingly, Article No.3 of the Code of Foreign Investment sets out a list of fields in which Egypt wishes to attract foreign investment. These fields are:

1. Industrialisation, mining, energy, tourism, transportation and others.
2. Reclamation of barren land and its cultivation, and projects for developing animal production and water wealth.
3. Projects for housing and for urban development.
4. Investment companies.
5. Banks engaging in local currency transactions, so long as they are in the form of joint ventures in which local Egyptian capital holds at least 51%.

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6. Technical consultant activities in the form of Joint Stock Companies in partnership with foreign international consultant firms subject to their being related to projects in the areas mentioned above. Thus the Egyptian government places no limitation on the entry of foreign investment into the various economic sectors except for the specification of strategic projects. However, the list of projects required is prepared annually by the Authority, based on the general national plan and the demands of each sector for foreign collaboration.

4.4.1.2 Ownership Policy

The Code of Foreign Investment (Article 4) and Law No. 159 of 1981 stipulate that foreign investment should take the form of a joint venture with public and/or private capital. As an exception to this general rule a foreign investment may be established without local participation conditional on the approval of two-thirds of the Authority's Board of Directors.

In general, the Code of Foreign Investment sets out rules concerning a foreign enterprise's ownership structure as follows:

1. Joint venture banks dealing in local currency must have 51% Egyptian participation.
2. Egyptian Capital must hold at least 51% of joint venture.
3. Technical Consultants must have 49% local participation (unless exempted by the Authority's Board of Directors).
4. 100% foreign wholly-owned projects are acceptable in special cases such as:

a) a branch of a bank situated abroad and conducting transactions exclusively in foreign currencies (Articles 3 and 4 of Law No. 43).

b) other investment projects conditional on the approval of two-thirds of the Authority's Board of Directors. Interviews with officials at GAFI indicated that the Board approves an investment project without local participation if:

(1) an appropriate local partner is not available.

(2) the project is unique in its contribution to the national economy in terms of the transfer of technology.

With certain exceptions referred to above, the Code of Foreign Investment does not lay down a strict minimum percentage for foreign investment in the joint venture. This is subject to negotiation between GAFI's officials and prospective investors. However, Law No. 159 of 1981 stipulates that local participation must be at least 49% for a stock company, while a limited liability company may be established without local participation.

4.4.1.3 Invested Capital

Article No. 2 of Law 43 of 1974 sets out the various types of permitted invested capital which may be classified into capital provided in cash, and capital provided in kind.

The first may take the form of foreign currency transferred to Egypt, and reinvested profits. The transfer
of foreign currency to Egypt must come through a bank registered with the Central Bank of Egypt. It should also be directed to a specific purpose.

The second may take the form of imported machinery, equipment, raw materials, or intangible assets such as patents and trade marks.

In the case of a joint venture, the local partner may contribute any of the above forms of capital with permission to provide Egyptian pounds or capital in kind, such as real estate.

4.4.2 Investment Application and Evaluation

The code of foreign investment requires each intending investor to submit five copies of an application for the establishment of a new project to the General Authority for Investment and Free Zones under law 43 of 1974, as amended by law 32 of 1977, and to the General Companies Administration and Capital Market Authority, which is interested in establishing Egyptian companies, especially finance companies.*

The application forms contain information about the applicant’s partners in the project and about the proposed

* Under Law 159, the application for the formation of a company is merely an application for the establishment of a company. The procedure does not involve the approval of a project. If a joint venture company is to carry out a particular project, then the approval of other ministries and government agencies is necessary, similar to the position under Law 43. The General Companies Administration and Capital Market Authority deal with such applications. The differences between the two laws were discussed in chapter III.
project, including:

A) Information regarding the technical aspects of the proposal, comprising two types of data: the first concerning the construction stage, and the second relating to the operation stage, including products to be produced, proposed rate of output, expected selling prices, amount of labour to be employed and expected wages, proposed source of materials inputs, and expected power capacity to be used.

B) Information regarding the capital to be invested in the project, including source of finance, interest on and repayment of borrowed capital, anticipated profitability, methods of distributing profits, amount of exports, and so forth.

The above information must be included within a preliminary feasibility study submitted to the respective authority (General Authority for Investment and Free Zones, and Capital Market Authority) for appraisal before its approval.

The General Authority for Investment and Free Zones, after receiving the technical view of the ministry or organisation responsible and consulting the investor’s bank or the Central Bank, studies the application in the light of the needs of the national economy (see Figure 4.1).

The decision of the Board of Directors relating to these applications is considered final. The Board’s decision includes all rules pertaining to state objectives and the investors’ goals such as the remittance of profits, capital repatriation and other incentives, according to the rules
set forth in law No. 43 and its executive regulation.

The applicant is informed of the Board’s decision and, if the project is accepted, its file will be passed to the department of performance evaluation and follow-up in the General Authority for Investment and Free Zones, which will take the necessary steps to follow up the implementation at all stages. Each investment project must be implemented in accordance with the basic criteria mentioned above and the objectives set forth in its feasibility study. Any failure of a project to abide by the conditions and objectives set by the state may result in its resubmission to the Board of Directors. Moreover, the project’s management must submit annually its financial statements, the auditor’s report and a copy of the project’s activity report to the follow-up department in the same authority.

Investment proposals are assessed from economic and financial points of view to ensure that they meet economic and social development objectives within the framework of the state’s national plan. Accordingly, the Authority evaluates each proposal in relation to the following rules:

1. The project must involve participation of private or public local capital, under the terms set forth in the code of foreign investment.
2. The proposal must state the labour force to be employed, the wages they will be paid, and the type of training to be provided.
Figure 4.1 Application Procedures*

1. **Investor**
   - (A) 5 Copies of the application form
   - (2) Project's feasibility study
   - (3) Equipment list
   - Filling Missing data

2. Project Evaluation
   - Dept of the Authority for Foreign Investment
   - Recommendations

3. **Technical View**
   - (B) Asking for information about investor
   - (C) Asking for technical view

4. **Technical Authority (Ministry) (Organisation)**

5. **Board of the Authority**
   - Decide
     - (E) Accept
     - (E) Reject

6. **Follow-Up Dept**
   - The Projects File


* The application procedures have not been changed since 1977.
3. The proposal should guarantee that a stated amount of funds will be transferred to Egypt in free foreign currency to establish the project.

4. The proposal should declare the anticipated level of production, and the expected local selling price compared with the selling price on the international market.

5. The project must be examined in terms of its expected effects on the balance of payments regarding export-orientation, import-substitution and the amount of foreign currency to be transferred in the form of profits remittance, capital repatriation, royalties, fees, etc. The financial evaluation also covers the project’s ability to meet its obligations, generate cash, and make a profit.*

With regard to the application procedures under the company law No. 159 of 1981, the General Companies Administration receives applications to found a shareholder or joint stock company under that law including ten copies of the company’s primary contract and statutes, with several other complementary documents to show that the correct procedure is followed in the project’s establishment (Executive Regulation of Law 159 of 1981).

If the documents are complete they will be referred by the administration to the committee appointed by ministerial decree for project evaluation. This committee includes a representative of the legislation department of the state.

* For more details see Squibb Egypt’s case study.
council, the general director of the General Companies Administration, a representative of the Capital Market Authority, a representative of the General Authority for Investment, and a representative of the Commercial Registration Department.

However, should the documents be incomplete, the investor concerned will be asked to provide the necessary information within ten days.

The main task of the committee is to examine each application in terms of the provisions of the law, its executive regulation, and current state objectives. If the project is approved, the decision will be conveyed to the founders or their agents by the committee secretary. However, if is rejected, the reasons will be given so that the potential investor may resubmit the application within 60 days of the date of refusal.

The process of control at entry therefore seems to be operated systematically. However, in many respects, it does not help the government to make sound decisions. This is basically due partly to the lack of social cost/benefit analysis and partly to lack of experience on the part of government analysts in evaluating the benefits to the country. This process requires a specialist staff, namely government auditors able to examine the project proposal with technical skills equal to those of the private analysts who prepare the project feasibility studies.
4.5 Operating Control System

Naturally, each activity is directed to generate either private and/or public benefits. These should be monitored and controlled according to the objectives for which they were approved. This section therefore outlines the process of control operated by the Egyptian government to monitor and follow up foreign enterprises once they have started production. The process of control here will be related only to the financial aspects rather than non-financial aspects. The later "administrative control" process will be discussed in detail in the Squibb case study. This process is carried out to ensure that the project is achieving its objectives and thus providing national benefits.

4.5.1 Financial Control

Financial control procedures refer to the investigation of the financial statements of foreign enterprises, which is undertaken by government officials in GAFI, and CMA, with the aim of (a) determining transferable funds including profits, and (b) evaluating company performance.

By virtue of Law No. 43 of 1974, each enterprise should submit its annual financial statements and other documents to the Follow-Up and Auditing Division. The main function of this division is to examine and investigate these documents aiming to:

1. confirm that the balance sheet shows the financial condition of the company in accordance with established accounting rules;
2. confirm that the profit and loss account shows the result
of the company’s operations for the year then ended in accordance with generally accepted accounting principles;

3. determine and approve the amount of funds including profits, which may be transferred;

4. satisfy itself that the national objectives intended to be achieved by the company are being met;

5. report to the Authority Board setting forth the auditing process operated by GAFI’s staff for the purpose of determining the amount of profits to be remitted and company performance evaluation.

By virtue of Law 159 of 1981, each joint stock company and limited liability company must each year provide the Financial Analysis Department (FAD) at the Capital Market Authority with a copy of its financial statements certified by a chartered accountant. One of the primary objectives of these financial statements is to enable the FAD to calculate the company’s financial ratios. The CMA uses these ratios to determine the financial condition and operating results of the company, to assess the past and present value of shares compared with book value, and to forecast future performance. In addition, the CMA should confirm that the company:

1. is able to meet its obligations to its creditors;
2. has earned sufficient foreign exchange;
3. has adequate liquidity.

However, problems arise in the auditing and analysis
undertaken by the above departments, due to differences between the accounting systems used by foreign enterprises and the uniform accounting system applied in Egypt. The authorities attempt to solve this problem by restating the financial statements provided by the foreign enterprise to accord with the Egyptian uniform accounting system. This matter will be discussed in detail in Squibb Egypt case study in part III.

The processes for determining the amount of transferable profits and evaluating project performance are now considered. For each of these aspects a particular control process is operated.

4.5.1.1 Exchange Control

Exchange control is perhaps the most important area of concern for foreign enterprises. It is often said that the Code of Foreign Investment permitted the right to foreign enterprises to remit, in whole or in part, their net profits, royalties, and management fees at the highest prevailing rate declared for freely convertible foreign currency within the limits approved by the Authority and subject to the foreign currency being acquired by the enterprise. In this respect, the government or the commercial banks have never made foreign currency available for remittance of profits or other funds and will not do so in the foreseeable future. Neither the government nor the commercial banks have sufficient funds available for this purpose. Yet the government attempts to ensure that profits
are earned through the enterprise's operations, and calculated without manipulation. To this end, the Follow-Up and Auditing Division's task is to determine the amount of funds, including profits which could be transferred. This analysis is often conducted as follows (Articles 26 of Executive Regulation of Law 43):

a) An application for remittance should be presented to the Follow-Up and Auditing Division at the GAFI stating the amount of profits sought to be remitted. The application should be accompanied by the company's balance sheet and income statement for the period in which the profits were earned, certified by a chartered accountant.

b) The Follow-Up and Auditing Division examines the submitted documents to ensure that:

(1) the enterprises has discharged all tax and other financial obligations due to the State;
(2) the enterprise's authorised capital has been completed and registered with the GAFI;
(3) the profits have been properly calculated in accordance with generally accepted accounting principles.

c) Based on the above examination, the profits may be recalculated in accordance with the rules of the uniform accounting system. In this case a letter indicating the result of the examination and the recalculated profits is sent to the enterprise. The enterprise's management is entitled to negotiate these matters until the two
parties agree about the enterprise's annual net profits.

d) Once the enterprise's profits have been agreed, the authority notifies the enterprise's bank of the amount of profits which could be transferred, according to the following procedures:

(1) Enterprises which have earned sufficient foreign exchange are allowed to remit their profits without any limit.

(2) Enterprises which have not earned sufficient foreign exchange may remit profits within limits approved by the GAFI. In practice, as explained during an interview, the GAFI's approval normally covers remittance of up to 25% of profits. Nevertheless, some enterprises may acquire foreign exchange from the free market in order to remit their profits in full.

Under Law 156 of 1953, similar procedures are used to determine the amount of profits to be remitted. However, as stated during interviews with the staff of the General Directorate for Foreign Currency the amount of transferable profit is determined as follows:

(1) Pharmaceutical companies, 60-70%;

(2) Hotels, 6-25%;

(3) Petroleum Companies, 100%;

(4) Financial Companies 100%.

In the case of companies operating under Law 159 of 1981, there is no provision in the law dealing with the
right of foreign shareholders with respect to profit remittance. However, it was stated during an interview with the General Manager of the CMA, that shareholders are permitted to acquire foreign currency in the free market and transfer it. This is covered by the exchange control legislation which grants permission to persons in the private sector to own foreign currency and dispose of it as they wish.

There are thus essential differences between the investment laws which govern remittance of profits. Law No.43 contains a guaranteed right to acquire and transfer foreign currency in terms of profits etc., which is not affected by changes in the exchange control legislation. On the other hand, Law 159 companies must rely on the exchange legislation, and they may be affected by any future changes in that legislation. For this reason, all major MNEs have chosen Law 43 rather than Law 159.

4.5.3 Evaluation of Performance

To evaluate a company's performance under Law 43, two main financial reports are presented by a company to GAFI. These reports are a follow-up report which is designed by the Authority itself, and the balance sheet and income statement of the company certified by an accountant.

The first report contains the following data:
1. capital structure of the company including sources of finance classified into foreign and local capital;
2. employment, including the number of employees
classified by nationality, and the wages and salaries for each group.

No specific format has been laid down for the financial statements of a company, and companies are left to present them in accordance with their own accounting system.

Based on the information extracted from these reports, the GAFI evaluates the company's performance in the following terms:

(1) Ensuring that the company is conducting the same activity as that approved by the Authority. This is simply measured by comparing current products with those specified in its feasibility study. If it is discovered that the company does not produce the items stated in its feasibility study and conducts other activities, action may be taken by GAFI.

(2) Ascertaining that the company has achieved a reasonable value added as stated in its feasibility study. This is measured by the form mentioned earlier, though it is incomplete, as will be seen later.

(3) Measuring the company's ability to meet its financial obligations and generate cash, and its efficiency in utilising its resources. These are evaluated by using the financial ratios computed by the GAFI, such as financial structure ratios, profitability ratios, liquidity ratios, and turnover ratios.

Under Law 159, the process of evaluating a company's performance starts with collecting the data required for
this purpose. Article 312 of Executive Regulation stipulates that a foreign company must provide the GCA, every year, with the following documents:

1. A copy of the balance sheet and income statement certified by an auditor’s report.
2. Realised profits and the workers’ share thereof.
3. The number of workers, their position, nationalities, and wages and salaries.

Based on the above data, the company’s operations are evaluated for the purpose of:

(1) Ensuring that the company’s operations are in accordance with the budget and the State’s objectives.
(2) Ascertaining that the company’s realised profits are distributed in an effective manner.
(3) Ensuring that the company employs the number of Egyptian workers stipulated in the law.

Having identified the process of control currently operated by the Egyptian government at the operating stage, several questions were discussed during interviews with the staff responsible for carrying out the process in GAFI and GCA.

The first question concerned the basis upon which the government officials review the financial statements submitted by foreign enterprises. It was stated that the statements are reviewed to ascertain the consistency of the valuation and calculation methods with established
accounting rules and principles. To this end, the government officials mainly rely upon the external auditor’s report which contains an opinion as to the fairness of the financial statements or whether they give a true and fair views of the state of the company’s affairs. The second question was "Why do government officials rely on a report prepared by an external auditor who is neither a government agent nor an appointee?" Although almost all the interviewees agreed on the difficulty of ensuring the independence of a private auditor, the following arguments were produced:

1. If the government agencies were to take on the whole auditing function, more qualified accountants would have to be employed. This is difficult, mainly due to the shortage of such persons and the unattractive salaries paid by the government compared with those available in the private sector.

2. The external auditors are Egyptians, and thus are expected to protect the national interest, or at least not to sacrifice national interests in favour of the company’s interests.

3. Foreign enterprises are normally reluctant to put their financial reports in the hands of the Central Agency for Auditing.

4. Although the external auditor’s report is the basis for reviewing company financial statements, the GAFI, for example, performs an office audit mainly to ensure that:

   a) the company has submitted its tax declaration and
The next question asked was what happens if the company employs transfer pricing techniques to overestimate its imports or underestimate its declared profits? In answering this question it was stated that if government officials are in doubt about the value of the enterprise's import or export transactions, then world prices are taken as the main norm in evaluating the company's declared profits. In response to the question, how often this happens, no specific answer was given; it was stated that this situation is considered especially with regard to a foreign subsidiary like Squibb Egypt which depends heavily on its parent company to obtain its input requirements.

The fourth question concerned the frequency with which company performance is evaluated. The answer to this question was disappointing, for there is no regular frequency at which the operations of foreign enterprises are evaluated. Nevertheless, evaluation is expected to help in identifying problems and suggesting what sort of solutions
should be sought.

The final question was about the use of financial ratios to appraise a company's performance. It was answered that the financial ratios are calculated for a number of recent years, and that the company's performance is evaluated on the basis of these.

There are therefore a number of control techniques by which the operations of a company are evaluated. However, the techniques currently operated are not as effective as they might be, due to some serious shortcomings:

1. The data submitted to GAFI through the company's financial statements, together with those collected through the follow-up report are insufficient to meet the requirements of the evaluation process. This is because the reports do not provide enough data about output, including volume and value classified into local sales and exports, and input including local and imported raw materials, and transfer prices of products or parts.

2. Although the financial statements submitted by the company are considered to be accurate because they are certified by an external auditor, it is difficult to ensure his independence, since he is paid by the company being audited. The national interest of an external auditor is very limited in respect of a number of issues such as transfer pricing, royalties and management fees. The performing of all auditing and investigating functions, therefore, should be the responsibility of the Central
Agency for Auditing as the government auditor has a great deal of experience of such issues, and a full effectiveness and efficiency audit should be carried out.

3. The current evaluation process ignores most of the objectives upon which the company's initial approval was based, as reflected in its feasibility study. These original criteria should be used as a set of performance standards, against which the actual performance should be compared.

4. There is no regular time or specified frequency for the performance evaluation process to be carried out. This results in failure to take the necessary corrective actions at the appropriate time.

5. The control process neglects the possibility that the enterprise may be using transfer pricing techniques to overestimate imported inputs and underestimate reported profits.

6. The process basically relies on various government bodies which causes problems for the company, as conflicting and confusing regulations are applied, affecting the implementation of decisions, and reducing the efficiency of the control process itself, and consequently the achievement of the hopes placed on the open door policy.

4.6 Conclusions

The purpose of this chapter has been to identify and examine the process of control currently operated by the Egyptian government over foreign companies at entry and during operations. In the first section, a number of
criteria were reviewed by which foreign investment proposals are evaluated, followed by an examination of the structure of the government agencies responsible for following up these projects. However, it was found that no priority ranking is given to the criteria applied to decide upon the acceptability of an investment proposal, and these criteria are not clearly defined.

The third section was concerned with the process of entry control. The discussion throughout this section indicated that the entry control system comprises a number of entry conditions, which lead to accepting or rejecting the proposed project from the technical, economic and financial points of view. However, it was discovered that this process has shortcomings which significantly reduce its effectiveness.

The final section is concerned with the following up of foreign companies during their operations. The process focuses on determining the amount of funds to be transferred, and evaluating the company's performance. However, the application of this process suffers from several shortcomings which significantly reduce its efficiency.

The above findings strongly suggest that the government should reappraise the existing control system. In the next part of this study, we will concentrate our attention on the control system (see Chapter II) which should be adopted by the Egyptian government to follow up the effects of these enterprises on the country's economic development, using
Squibb Egypt as case study for this purpose. This system cannot be effectively operated without criteria for the accurate measurement of the benefits generated, and the performance of an audit function in order to evaluate the company's operations annually, to ensure that actual operations are carried out in accordance with the objectives on which a project's approval was based.
Part III
The Case Study
Government Control over Squibb
Egypt
Chapter V
Squibb Egypt - A General Overview

5.1 Introduction

This chapter is mainly devoted to a discussion of the development of Squibb Egypt within the Egyptian pharmaceutical industry. First, the historical development of the Egyptian pharmaceutical industry is discussed up to the current decade when Squibb Egypt started production.

Secondly, the background of the Squibb Corporation is described, following which, the main features of the operating results and organisational structure of Squibb Egypt are discussed.

5.2 Historical Development of the Egyptian Pharmaceutical Industry

The pharmaceutical industry in Egypt originated at the beginning of the 1930s with a small number of laboratories engaged in the production of a very few standard pharmacopeal preparations for use in Egypt (CAPMS, 1987,p.8). In 1939, a second large pharmaceutical company, "Memphis" was established, with capital of L.E. 40,000.

In 1947, a third large pharmaceutical company, called "CID" or "Chemical Industries Development", was set up by a private Egyptian capitalist, with authorised capital of L.E. 250,000. At the beginning of the 1950s the company's performance was poor due to enormous difficulties in its finances and management, and the lack of imported raw
materials and semi-finished drugs.

In 1956, CID decided to seek the cooperation of a Belgian firm, "Union Chimique Belge", through an agreement to reorganise production and distribution. For the first time, a domestic firm became the licensee to an international pharmaceutical enterprise which could provide it with know-how and finance.

Although there were three large domestic companies by the late 1950's, output was small and they struggled to maintain a 10% share of the home market. A few years later, foreign enterprises began to participate. The power of the MNE's operating in this industry has been based on three main factors:

(1) Heavy expenditure on R & D which has been instrumental in generating a flow of innovations, mostly patented (UNCTAD, 1981);

(2) Enormous expenditure on sales promotion, including the extensive use of advertising, trade marks, free samples and trained salesmen;

(3) A significant cash flow which has been used to finance technological and marketing expenditure, and to expand exports to most countries of the world.

All domestic firms relied on the import of raw materials and drugs in their bulk finished form, together with necessary packaging materials. In addition, the Egyptian consumer market has depended for its supply of drugs on imports from approximately 100 foreign
pharmaceutical companies, with 88 agents engaged in the import and distribution of more than 20,000 foreign drugs. They accounted for 90% of the total market during the late 1950's and early 1960s (CAPMS, 1987).

It was clear to government authorities that the only way to overcome this situation was to attract foreign enterprises. Bargaining on the terms of agreements took place between foreign companies and the ministry of industry. The main subjects of argument were the ownership of the subsidiaries and the extent of control by government.

The first large foreign pharmaceutical enterprise to come to Egypt was PFIZER-MISR, followed by HOECHST-ORIENT. They set up in Egypt in 1962 with an authorised capital of L.E. 1.200 and 0.624 million respectively, operating as joint-ventures between their parent companies in U.S.A and West Germany and Egyptian public and private shareholders. One year later, "SWISS PHARMA" was established as a shareholders company with authorised capital of L.E. 0.333 million. This company is the subsidiary of a consortium of three Swiss international firms, Ciba, Wander, and Sandoz.

At the same time, three domestic companies were also established: "NILE" "EL KAHIRA" and "ALEXANDRIA" with a capital of L.E. 5.828, 3.141, and 1.521 million respectively. In the following year, the government set up another two public pharmaceutical companies, "ARAB" and "NASR", with an authorised capital of L.E. 1.857 and 8.000 million respectively.

In addition to the above manufacturing pharmaceutical
companies, four companies producing auxiliary materials used in the manufacture of pharmaceuticals were also established and placed under the General Organisation of Drugs. Two of these were absorbed into existing pharmaceutical firms and the other two were merged to form the Pharmaceutical Packaging Company. Two commercial companies were also set up to undertake the distribution of pharmaceuticals.

Thus, the number of manufacturing companies established up to the end of 1965 was eleven, with a capital of L.E. 33.4 million. Eight companies were local, with capital of L.E. 31.3 million, i.e. 72.7% of the total Egyptian pharmaceutical industry. Six local distribution and commercial companies were also set up.

With the open door policy came the replacement of the state agency by an inter-ministerial committee, the Technical Committee for Drugs; chaired by the Minister of Health, and the decentralisation of the public sector. Foreign enterprises were given greater incentives, and in 1979, the first foreign subsidiary, "Squibb Egypt", was set up with an authorised capital of L.E. 3.5 million, followed by three foreign companies, two of which operated as joint-ventures. These companies began production in 1986. So far, the new approach to foreign investment has had little effect on the pharmaceutical industry. However, the public sector, composed of eight state-owned enterprises, was reported at the end of the five year plan 1982-1987 to be facing a major financial crisis, in part the result of price
controls (GOD, 1987). These companies made a total loss of $16 million, although a direct government subsidy to the industry during the five year plan amounted to $21 million.

Nevertheless, these enterprises have made significant progress over the past 20 years and are now able to meet close to 70% of the country's needs. In the meantime, the foreign joint-venture companies and one wholly-owned subsidiary are also playing an important role in the production of drugs.

Table 5.1 gives a brief description of the composition of the Egyptian pharmaceutical industry.

It can be seen that seven foreign enterprises accounted for 46.7% of the total pharmaceutical industry in Egypt in 1986 with capital of L.E. 63.0 million (i.e. 38.4%) and 2002 workers (i.e. 10.7%). In addition, their sales were estimated at L.E. 186.6 million (i.e. 34.9% of total market sales).
<table>
<thead>
<tr>
<th>Name of enterprise</th>
<th>1st year of production</th>
<th>Capital 1986 L.E.m</th>
<th>Number of Employees 1986</th>
<th>Sales 1986 L.E.m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Private sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-Pfizer -Misr</td>
<td>1962</td>
<td>8.2</td>
<td>466</td>
<td>27.3</td>
</tr>
<tr>
<td>2-Hoechst -Orient</td>
<td>1962</td>
<td>5.7</td>
<td>502</td>
<td>45.1</td>
</tr>
<tr>
<td>3-Swiss -pharma</td>
<td>1965</td>
<td>10.5</td>
<td>497</td>
<td>63.2</td>
</tr>
<tr>
<td>4-Squibb Egypt</td>
<td>1979</td>
<td>17.0</td>
<td>316</td>
<td>40.8</td>
</tr>
<tr>
<td>5-Ibico</td>
<td>1986</td>
<td>9.5</td>
<td>221</td>
<td>10.2</td>
</tr>
<tr>
<td>6-ABI</td>
<td>1987</td>
<td>6.7</td>
<td>95</td>
<td></td>
</tr>
<tr>
<td>7-Farco</td>
<td>1987</td>
<td>5.4</td>
<td>105</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>63.0</td>
<td>2202</td>
<td>186.6</td>
</tr>
<tr>
<td><strong>Public sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1-Alexandria</td>
<td>1963</td>
<td>8.0</td>
<td>782</td>
<td>29.7</td>
</tr>
<tr>
<td>2-CID</td>
<td>1950</td>
<td>15.2</td>
<td>3000</td>
<td>57.3</td>
</tr>
<tr>
<td>3-Arab</td>
<td>1964</td>
<td>5.8</td>
<td>1543</td>
<td>22.6</td>
</tr>
<tr>
<td>4-Misr</td>
<td>1937</td>
<td>14.2</td>
<td>2320</td>
<td>42.5</td>
</tr>
<tr>
<td>5-Memphis</td>
<td>1940</td>
<td>13.1</td>
<td>1900</td>
<td>36.5</td>
</tr>
<tr>
<td>6-Nile</td>
<td>1963</td>
<td>15.9</td>
<td>2800</td>
<td>63.5</td>
</tr>
<tr>
<td>7-EL-Kahira</td>
<td>1963</td>
<td>15.7</td>
<td>2050</td>
<td>51.7</td>
</tr>
<tr>
<td>8-EL-Nasr</td>
<td>1964</td>
<td>13.0</td>
<td>2097</td>
<td>43.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>100.9</td>
<td>16492</td>
<td>347.3</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td></td>
<td>163.9</td>
<td>18694</td>
<td>533.9</td>
</tr>
</tbody>
</table>

Source: The General Organisation of Drugs

### 5.3 Background of Squibb Corporation

Before 1900, the Squibb Corporation (E.R Squibb & Sons, Inc.) had established itself in the field of pharmaceuticals in the U.S.A, and later diversified into two secondary types of products: medical products (Conva Tec focused on ostomy, wound care, skin care and incontinence products, while the
Weck companies were responsible for surgical instruments, closures and hospital disposables) and confectionery, food services, perfumes and cosmetics.

The corporation’s main products include pharmaceuticals for human and veterinary use as well as diagnostic agents and surgical and ophthalmic instruments. Pharmaceutical products include agents for the prevention, diagnosis and treatment of disease, with emphasis on products for cardiovascular disease, infection, inflammatory disease and diagnostic medicine. Squibb also produces antibiotics which include radiopharmaceuticals, such as the minitec generator used as a source of Technetium 99m, Albumotope-Ls for the lungs and sethotope for the pancreas. Moreover, high-potency vitamins and veterinary products are produced, including corticosteroids, antibiotics, anthelmintics and food additives. Proprietaries and household products including aspirin, mineral oil, cough and cold products are also produced.

The corporation owns foreign subsidiaries around the world with more than 39 branches with an authorised capital of $103 million at the end of 1986.

Squibb Corporation has over 43% of its total business in foreign markets, returning dollars to the head office in U.S.A of around $325 million. In 1985 the total worldwide sales (see table 5.2) were $1.403.8 million, and they increased by 27.1% in 1986 to $1.784.6 million, and in 1987
to $2.156.5 million. Profits reached $506.2 million in 1987 a 47.8% increase from 1986.

Table 5.2

Sales and Profits of the Squibb Corporation, up to 1987, by Geographic Area

(Value in million dollars)

<table>
<thead>
<tr>
<th>Years</th>
<th>International</th>
<th>Adjustment/elimination*</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Domestic</td>
<td>Europe</td>
<td>other</td>
</tr>
<tr>
<td>-------</td>
<td>---------</td>
<td>--------</td>
<td>-------</td>
</tr>
<tr>
<td>1987</td>
<td>1.219.4</td>
<td>689.3</td>
<td>247.8</td>
</tr>
<tr>
<td></td>
<td>305.3</td>
<td>97.4</td>
<td>3.5</td>
</tr>
<tr>
<td>Interarea sales</td>
<td>1.524.7</td>
<td>786.7</td>
<td>251.3</td>
</tr>
<tr>
<td></td>
<td>398.3</td>
<td>126.2</td>
<td>(9.3)</td>
</tr>
<tr>
<td>Profits from operations</td>
<td>1.016.9</td>
<td>525.9</td>
<td>241.8</td>
</tr>
<tr>
<td></td>
<td>308.2</td>
<td>92.9</td>
<td>4.5</td>
</tr>
<tr>
<td>Interarea sales</td>
<td>1.325.1</td>
<td>618.8</td>
<td>246.3</td>
</tr>
<tr>
<td></td>
<td>364.6</td>
<td>52.9</td>
<td>(81.8)</td>
</tr>
<tr>
<td>1986</td>
<td>812.1</td>
<td>374.0</td>
<td>217.7</td>
</tr>
<tr>
<td></td>
<td>188.3</td>
<td>144.2</td>
<td>0.1</td>
</tr>
<tr>
<td>Interarea sales</td>
<td>1.000.4</td>
<td>518.2</td>
<td>217.8</td>
</tr>
<tr>
<td></td>
<td>237.4</td>
<td>125.3</td>
<td>(9.3)</td>
</tr>
</tbody>
</table>


* Geographic area adjustment/elimination are comprised of interarea sales, the net change in interarea profit in beginning and ending inventories and interarea profit in ending inventories.
Squibb Corporation has achieved significant progress, founded on two factors: firstly, greatly improved operating performance resulting from the reorganisation of the corporation, completed in 1986, and the success of its products in the marketplace, and secondly, the productivity of its research and development programmes in providing new products.

Squibb evaluates its subsidiaries' performance on the basis of sales and earnings growth and other factors. However, Squibb Egypt also needs to be assessed in terms of Egyptian government criteria, and our aim in this case study is to focus on the only foreign enterprise in the Egyptian pharmaceutical industry which is a wholly-owned subsidiary of a multinational enterprise.

5.4 A Brief Overview of Squibb Egypt's development

As we have seen earlier, under the code of foreign investment of 1974, the Egyptian government encouraged foreign investment, partly because of the high technology which would be brought into the country, and partly because of other expected contributions to the national economy. The pharmaceutical industry is one of the economic sectors in Egypt in which the activities of foreign enterprises have been significant. Considerable attention has been paid by the government authorities to promoting them, partly to expand the local manufacture of drugs, and partly to improve their quality. Thus Squibb Company agreed at the beginning of 1974 to enter the pharmaceutical sector as a foreign
wholly-owned subsidiary. The manager of the subsidiary, in an interview, (Dec, 29, 1987) pointed out that:

"Although the head office of the corporation had several opportunities to set up this plant in many other developing countries, especially, in the Middle East, the choice of Egypt as a favourable place for its establishment was based on the one hand, on the awareness that the chance might not be available for long; on the other hand, setting up of this branch was helped by the abolition of the Lebanon's subsidiary."

The Squibb Egypt company is a subsidiary of the Squibb Corporation, located in U.S.A and registered in Panama for taxation and tariffs purposes. Its main objectives in Egypt are to introduce its products to both local and foreign markets; to develop drugs; to develop the demand for its products, and to build an export market. In addition, it will increase national output, create employment for Egyptian nationals, and assist import substitution by reducing dependence on drug imports. On the other hand, opportunities for achieving domination, diffusion, and profitability were also among its main aspirations in the Egypt and the Middle East region. The General Manager of the subsidiary states (Ibid):

"The decision on the part of Squibb to come to Egypt was based on the confidence we have in this country as a sound risk. Egypt represents the core of the geographical region and it is the place to be, if one is looking towards future gains. We feel that projects such as the one we are involved in will be mutually profitable to both foreign enterprises and to Egypt."

At the end of 1974, Squibb Egypt had been given the
green light to operate in Egypt producing a variety of pharmaceutical products. The initial capital amounted to L.E. 3.5 million, and investment costs totalled L.E. 5.8 million. The initial production capacity was estimated at 10 million units with production costs of L.E. 9.5 million. This required 229 workers with wages amounting to L.E. 0.631 million. Table (5.3) shows the development of production, sales, employment, and raw materials during 1979-1986.

From the data in the table it is clear that in many areas, the subsidiary has made significant progress. Pharmaceutical production was 8 million units in 1984, double that of 1979. After extensions at the plant, production had increased to 18 and 18.5 million units by the end of 1986 and 1987 respectively. Sales for 1986 were L.E. 40.747 million, an increase of 38.6% from 1985, and almost four times the 1979 figures. However, production costs seem high, perhaps because Squibb Egypt is reducing its reported profits for tax purpose.

Turning to employment, the subsidiary employs a far greater proportion of highly skilled and semi-skilled personnel than of labourers. The actual employment amounted to 318 workers with wages totalling L.E. 2.510 million in 1987, and 316 workers with wages of L.E. 2.042 million in 1986. In this respect, in comparison with total employment in the pharmaceutical industry, the subsidiary’s employment ratio was very small (see chapter X).
<table>
<thead>
<tr>
<th>Year</th>
<th>Units of production (M)</th>
<th>Sales LE.(000)</th>
<th>Cost of production LE.(000)</th>
<th>Employment NO. wages LE.(000)</th>
<th>Raw materials LE.(000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>4.000</td>
<td>9.750</td>
<td>9.800</td>
<td>229</td>
<td>0.631</td>
</tr>
<tr>
<td>1980</td>
<td>4.500</td>
<td>11.300</td>
<td>10.200</td>
<td>238</td>
<td>0.678</td>
</tr>
<tr>
<td>1981</td>
<td>5.200</td>
<td>12.800</td>
<td>10.900</td>
<td>242</td>
<td>0.689</td>
</tr>
<tr>
<td>1982</td>
<td>5.600</td>
<td>13.115</td>
<td>11.500</td>
<td>245</td>
<td>0.719</td>
</tr>
<tr>
<td>1983</td>
<td>6.000</td>
<td>13.586</td>
<td>13.600</td>
<td>249</td>
<td>0.764</td>
</tr>
<tr>
<td>1985</td>
<td>16.000</td>
<td>29.389</td>
<td>29.400</td>
<td>318</td>
<td>1.507</td>
</tr>
<tr>
<td>1986</td>
<td>18.000</td>
<td>40.747</td>
<td>40.700</td>
<td>316</td>
<td>2.042</td>
</tr>
</tbody>
</table>


The table also shows that the ratio of labour cost to production cost is relatively small compared with the ratio of total raw materials. The average percentage of labour cost during the 1983-1986 period was 5.3%, against 6.3% for the previous period. This decline was due, as explained by the financial manager in an interview in 1988, partly to the employment policy adopted by the headquarters of the corporation, and partly to the high technology transferred to the subsidiary by the parent company. In this respect, he asserted that the number of production workers decreases considerably every year as a result of technology imported from the parent company.

Furthermore, he claimed that although the subsidiary paid relatively high wages and salaries to employees, it has
the lowest ratio of labour cost to production cost in comparison with other sister subsidiaries. The average percentage of labour cost to production within sister subsidiaries was approximately 17 per cent in 1986.

The percentage of imported raw materials cost to production at factor cost was 70.2% in 1987, and 69.9%, and 74.7% and 79.6% in 1986, 1985 and 1984 respectively. This is because Squibb Egypt’s products are mostly based upon raw materials imported from within the group. It is also noticeable that the ratio of raw materials cost is almost identical for each of these years. This stability is attributable to two main factors. One of these is that the use of the corporation brand name and production depends completely upon the corporation’s raw materials. In this context, the financial manager (Jan, 15, 1988) affirmed that:

"All drugs manufacturing processes in Squibb Egypt must be based on research of the Squibb Institute for Medical Research and products must carry the Squibb trade mark. As a consequence, all active raw materials of drugs must be imported from within the Corporation family. This is because the drugs’ active ingredients are measured in thousandths of a gram and must be tested in accordance with exacting standards of quality control."

The production manager of the subsidiary affirmed that approximately 90% of raw materials used in production are bought from within the group. The second factor is the overpricing of raw materials, which can be observed from comparison of costs between Squibb Egypt and national
domestic enterprises. The average percentage of imported raw materials used in production by local enterprises was 48.3% during the last three years (GOD, 1987, pp.45-52). This problem in relation to raw materials can be attributed to lack of government control over the price at which these raw materials are obtained, compared with competitive international prices.

To summarise the above analysis, the subsidiary has a relatively high manufacturing cost, and employs a comparatively small labour force. However, low labour costs have not resulted in lower operating costs as a whole. In addition, prices of imported raw materials used by the subsidiary are higher than those used by local enterprises, a fact which is not surprising since most of the drugs produced by foreign subsidiaries are patented. Higher-priced raw materials have been used in order to achieve lower income tax, and easier transfer of funds.

5.5 Organisational structure

The subsidiary’s foreign General Manager, who is appointed via the corporation’s Board of Directors manages the affairs of subsidiary. In addition, there are six Egyptian auxiliary managers who are in charge of the subsidiary’s main divisions. These seven managers constitute the subsidiary’s top management. They deal with both parent and Egyptian government officials in connection with problems of planning, control, and evaluation.
However, in an interview with the personnel manager of the subsidiary on 28th Dec, 1987, it was stated that the subsidiary's organisational structure is now under modification. The new structure will be divided into two areas, the first dealing with plant, especially production, and the second with marketing in the Middle East region. These two sections will be the basis of the future structure of the Squibb subsidiary in Egypt, and will be under the control of one manager. However, this organisational structure has so far not been implemented and is still under consideration.

5.6 Conclusions

This chapter has traced the development of the Egyptian pharmaceutical industry through the four decades 1940-1980. The analysis has shown that the pharmaceutical industry is divided into two sectors. The private sector consists of seven subsidiaries of multinational enterprises, five of them operating as joint ventures between their parent companies and Egyptian ownership, the latter having 51% of share capital, and the rest are foreign wholly-owned subsidiaries including Squibb Egypt. Squibb Egypt is completely controlled by a foreign management under the Egyptian Arab and Foreign Investment law No.43 of 1974 which, although it stipulated that foreign enterprises wishing to invest in Egypt should normally be joint ventures with shared local capital, permitted the establishment of foreign wholly-owned subsidiaries if
approved by a two-thirds majority of the GAFI's Board of Directors.

Secondly, it was concluded that Squibb Egypt has achieved significant progress in terms of its production levels. Further analysis of its financial and non-financial performance is provided in later chapters. However, in the following three chapters, attention is paid to the systems currently operated by the Egyptian government to control Squibb Egypt and to find out how it might need to be developed in the light of the host government control model previously outlined.
Chapter VI
Entry Control Devices

6.1 Introduction

Project evaluation at the entry stage is a very important element in the determination of potential benefit to the country, and in monitoring the project during its operational life. This chapter deals with the Egyptian control system as applied to Squibb Egypt, focusing on the application procedure and evaluation of the feasibility study from the technical, financial and economic points of view.

6.2 Government Targets and Policies

As previously mentioned, the open door policy aimed to promote economic growth. The main policy was that the major interest in ownership and effective control should normally be in Egyptian hands, but exceptional cases would be dealt with in a manner calculated to serve the national interest.

In the case of Squibb Egypt, exceptions to this principle of Egyptian ownership were allowed, in the expectation of the following benefits:

1. technological improvement of products and manufacturing methods;
2. an increase in employment of Egyptian nationals;
3. an increase in national output;
4. export opportunities;
5. import substitution by reducing dependence on imports.

Incentives influencing the decision of the Squibb
Corporation to invest in Egypt included the large local market, access to other Middle Eastern markets, the facilities and the labour force available, low wage rates, cheap raw materials, and tax and duty concessions.

At the beginning of the 1980's, increasing stress was laid on the need for import substitution in a situation where foreign exchange was needed for capital imports to sustain further economic growth, and on a future trend towards export orientation.

By the mid 1980's the government was becoming more concerned about the need to accelerate the pace of economic development within an atmosphere of stability. Government statements affirmed the policy of non-interference with the freedom of the private sector to invest in various fields of the economic activity to meet the needs of the country.

Within this framework, government support is governed by the following principles (Sidhom, 1986, p. 7):

1. No restrictions are imposed on foreign enterprises which will increase domestic production.

2. The government role is to encourage the private sector to participate more effectively in development efforts.

3. The realisation of profits is seen as a measure of success for private economic activity; the only obligation on the private sector is compliance with tax laws.

4. Final approval of new projects rests with a single official institution.
It is argued that these principles are insufficient. The government should consider not only profitability, but also cost and benefits to the economy as a whole, such as value-added, additional employment created, and impact on the balance of payments.

6.3 Application Procedures

By mid-1974, the recommendation to set up Squibb Egypt was passed by Headquarters to the Lebanon subsidiary with a request for the Klynveld Peat Marwick Goerdeler Company (KPMGC) to prepare the feasibility study of a proposed Egyptian subsidiary project, covering not only the Middle East but also all Arab Countries. On 5th October 1974, the feasibility study was completed by KPMGC, and 5 copies of this report was submitted to the Ministry of Health. Normally this report should have been submitted to the Foreign Investment Authority, but at the time it was undergoing a reorganisation.

The study was divided into four parts. The first and second parts were concerned with the project location, initial investment cost, source of materials, quantity of labour and expected wages, expected exports, and the quantity and value of production. They also covered capital to be invested, sources of finance, currency to be used in finance, interest and repayment of borrowed capital, and anticipated profitability. The third part discussed the factors affecting the Egyptian government, e.g. drug prices, production size, market sales at a reasonable price,
creation of jobs, import substitution and export-orientation and infrastructure facilities. Part four contained the summary and recommendations.*

6.3.1 Location

The project is situated 10km east of Giza City, overlooking the pyramids, some half a kilometre south of El-Ahram highway which links Giza, Cairo and Alexandria. It is sited in the middle region of El-Kahira- El-Kopra to facilitate production, marketing and distribution.

The total area of the project is 40,000 square metres, including laboratories, offices, stores and restaurant. These cover a net area of 25,000 square metres. The remainder is given to access roads and parks. The plant was designed with the technical assistance of the International Squibb Corporation.

6.3.2 A Brief Discussion of the Feasibility Study

Table 6.1 summarises the information contained in the feasibility study, presented to the Health Ministry in 1974. This study contained the various financial transactions that would subsequently be compared with the project’s actual performance. In addition, non-financial data related to the operating plan of the subsidiary were also provided, for

* Unfortunately, the researcher could not get a copy of the original feasibility study of the subsidiary due to administrative problems with regard to government officials or the subsidiary itself. However, most of the data relating to it had already been collected from interviews with General Organisation of Drugs' staff and the subsidiary’s management.
Table 6.1
Squibb Egypt Feasibility Study
(Value in L.E. millions)

<table>
<thead>
<tr>
<th></th>
<th>Foreign</th>
<th>Local</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of investment</td>
<td>4.0</td>
<td>1.5</td>
<td>5.5</td>
</tr>
<tr>
<td>Capital investment</td>
<td>3.5</td>
<td>-</td>
<td>3.5</td>
</tr>
<tr>
<td>Size of drugs production</td>
<td>-</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Percentage of export/sales</td>
<td>75%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of production</td>
<td>9.5</td>
<td>9.5</td>
<td></td>
</tr>
<tr>
<td>Value of Sales</td>
<td>7.875</td>
<td>2.625</td>
<td>10.5</td>
</tr>
<tr>
<td>Number of workers</td>
<td>229</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages</td>
<td>0.024</td>
<td>0.607</td>
<td>0.631</td>
</tr>
<tr>
<td>Loans</td>
<td>2.0</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>The expected period of</td>
<td>5 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>construction</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency used</td>
<td>Dollars &amp; L.E.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>3.2</td>
<td>3.2</td>
<td></td>
</tr>
<tr>
<td>Expected annual imported</td>
<td>70%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>raw material costs</td>
<td>of total cost of material</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected annual wages rate</td>
<td>5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected overheads</td>
<td>5-15%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expected rate of return</td>
<td>20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment appraisal method</td>
<td>Pay back</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit after</td>
<td>0.700</td>
<td></td>
<td></td>
</tr>
<tr>
<td>depreciation and tax</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


example the number of workers, level of production and the expected period of construction.

According to the above, the cost of investment required for the first stage was L.E. 4 million in foreign currency and L.E. 1.5 million in local currency. This was estimated on the basis of the actual set-up cost of the Lebanese subsidiary plus an addition of 15% for price increases. In the same way, production costs were estimated at L.E. 9.5 million for an expected 4 million units of drugs. The manpower required for the subsidiary was estimated to be 229
workers with an annual cost of L.E. 0.631 million, i.e. 5% of the value of sales. The expected annual cost of imported raw materials amounted to 70 per cent of the total material costs. Selling prices were limited by the Egyptian pricing policy for the pharmaceutical industry. A five year pay back period was adopted to evaluate expected annual revenue, which was estimated at 20 per cent.

After receiving copies of the feasibility study, the Department of Foreign Investment at the Ministry of Health sent a copy of the report to the Technical Department at the Organisation of Drugs, which is responsible for examining new proposed projects in the pharmaceutical sector, to obtain an assessment of the standard of technology to be used. The Technical Department submitted its recommendation a month later. If the department does not receive a reply from the Technical Department within two months, the project is automatically considered to be approved as far as its technology is concerned.

In the meantime, a copy was passed to the General Authority for Foreign Investment and Free Zones for an opinion on the consistency of the project with the investment laws of the country in general and those affecting the pharmaceutical industry in particular. The National Bank of Egypt was also furnished with a copy, in order to examine Squibb Egypt’s financial position.

At this stage, the Department of Foreign Investment at the Ministry of Health compiled all the data and enquiries
Figure 6.1
Application Procedures of Squibb Egypt

Source: Based on interviews with Organisation of Drugs, Foreign Investment Authority and the subsidiary itself.

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from the various government agencies and departments mentioned above, after which the feasibility study was examined by a group of experts in the Organisation of Drugs. These were specially trained in project evaluation techniques, and four broad questions were investigated:

1. Was the feasibility study consistent with the national plan?
2. Was the setting up of this project consistent with the relevant investment laws?
3. Was the project’s financial position consistent with the country’s norms?
4. Did the technical data submitted by the technical department suggest that the project would provide sufficient products at reasonable prices?

On the basis of reports on these issues, a recommendation was passed to the Organisation’s Board of Directors, who meet twice every month. They discuss the strategic plan of the organisation and give the final decision for acceptance and rejection of proposed projects. The Squibb feasibility study was accepted not only by the Organisation’s Board of Directors but also by the State Cabinet, and management was informed of the Cabinet’s approval on December 15th, 1974. After approval, a copy of the project file was passed to the investment tax district office who were to take the necessary steps to examine the financial statements in the light of tax regulations at the end of each year.
To sum up, it should be noted that the Department of Planning and Follow-up at the Organisation of Drugs, and the Department of Follow-up and Project Evaluation at the Investment Authority are the bodies responsible for the implementation procedures and monitoring the project to its completion (see figure 6.1).

6.4 Evaluating Squibb's Feasibility Study

Interviews held with government officials at the Department of Project Evaluation of the Arab and Foreign Investment Authority, and the Department of Planning and Follow-up at the Organisation of Drugs, revealed that both financial and economic criteria are used in judging a project's profitability.

6.4.1 Financial Analysis

The financial criteria used in examining a feasibility study in Egypt are based on the assumption that a proposed project will meet its obligations and make profits for taxation and reinvestment.

Thus the government officials who are responsible for dealing with these matters use the ratio of net profit/invested capital as the financial criterion to measure the profitability of the project at the feasibility stage. During an interview with officials at the Department of Project Evaluation of the Investment Authority and the Department of Investment of the Ministry of Planning, it was explained that ultimately, the criterion used is the accounting rate of return on equity or cost of investment.
and net profit/sales. However, the required rate varies from one project to another according to the economic sector involved. For the pharmaceutical sector, the required rate of return on investment used in evaluation is around 12-30 percent as mentioned in chapter four.

The Egyptian Committee of Projects Evaluation at the Organisation of Drugs relied upon the accounting rate of return, in the form of net profit/total investment, in judging Squibb's profitability. This rate was computed on the basis of total investment divided by the average net profit as shown in the feasibility study. The average net profit was estimated at L.E. 0.700 million. The profitability rate is thus calculated as follows:

\[
\text{Return on investment} = \frac{\text{expected net profit}}{\text{total investment}} = \frac{0.700}{5.500} = 12.7\%
\]

This ratio was consistent with the norms set for the pharmaceutical industry. One official at the Department of Performance Evaluation argued that the rate of return on investment provides a starting point from which to make comparisons and indicate performance trends. Moreover, it assists government officials in controlling and following up the subsidiary based on factors affecting the return on investment (interview on 22nd Jan, 1988).

However, the faults of this method are clear, particularly in relation to government decision-making. The accounting rate of return ignores inflation, foreign exchange rates, and the costs and benefits over the project's life. The financial results for the project, from
its first year to the present, were negative and the losses were too high. Thus, the question arises whether the feasibility study was inaccurate and whether estimates of future operational costs and revenues were ineffectively audited.

It appears that the investigation of Squibb’s feasibility study regarding financial profitability was not performed well by the government authorities, who concentrated their analysis upon just one financial ratio. This was due partly to lack of experience and training and partly to lack of coordination among the evaluators. A further problem in correctly calculating profitability, arises from differences in the accounting policies used by the Squibb Corporation and the uniform accounting system applied in Egypt, which will be considered in chapter 7.

Those responsible for evaluation should make a comprehensive financial analysis of the project. Firstly, all the costs and benefits over the project’s life must be identified in terms of quantity and value. Secondly, capital repatriation, profit remittances, fees and royalties should then be taken into consideration to determine their impact on the balance of payments. Thirdly, transfer pricing practices should also be monitored. In this context, a government official at the Department of Planning and Follow-up at the Organisation of Drugs was asked what would happen were Squibb to use transfer pricing to overstate its imports. He explained that the prices for the proposed
project's imports were based on the international market and were to be used as a basis for future comparison. Moreover, the Organisation checked the import prices quoted by Squibb. This is true; the evidence is that the cost of raw materials and intermediate imports is included in the feasibility study according to government requirements. However, the lack of government administrative and financial control during the project's life enabled the subsidiary to transfer funds to the parent company by this means.

Generally speaking, financial analysis of a project requires an examination not of one financial ratio alone but of all financial aspects in order to determine the impact of the proposed project on the economy and society as a whole.

To begin with, the state monitor should carry out efficiency and effectiveness audit as well as a compliance audit upon the feasibility study. This would involve careful auditing of the quantifiable costs and benefits, both at the feasibility study stage and later, the non-quantifiable effects being described but not evaluated. In addition, the expected rate of return, pricing policies, inflation, currency fluctuation, etc. must be taken into consideration. It will also be necessary to harmonise the company's accounting system with the uniform accounting system in order to provide appropriate data for efficiency and effectiveness audit. The government authorities have begun to tackle this latter problem by adapting accounts provided by prospective investors to the Egyptian accounting system.
6.4.1.1 The Subsidiary's Production Capacity

The subsidiary's capacity was estimated at 4 million drug units for the first year of production, but this level was steadily increased beyond what the Ministry of Health considered to be the norm for the pharmaceutical sector. It was therefore decided to expand capacity beyond that first estimated, with excess output exported to neighbouring countries. In the event, though production volume more than doubled within a few years, by the time the plant was working at nearly full capacity, the output of cardiovascular drugs and psychotropics was insufficient to meet the requirements of the Egyptian market.

6.4.1.2 Investment in the Project

Table 6.2 shows the capital costs of Squibb Egypt with a comparison of actual and estimated figures for 1979, the first year of operation. It is important to note that the completion of the plant was delayed compared with the feasibility study. The actual time for setting up the project was approximately 5 years from the date of approval. This was because of numerous difficulties which arose during the construction period, such as:

1. the bureaucratic complexity of government procedures for issuing the licenses required for supplying water, power, electricity and other infrastructure services;
2. the shortage of such infrastructure and transportation facilities in the remote area which the project is located;
3. the lack of government procedures and customs facilities
Table 6.2
Estimated and Actual Balance Sheet of Squibb Egypt
Value in L.E. million

<table>
<thead>
<tr>
<th></th>
<th>1979 Estimates</th>
<th>Actual Figures for 1979</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>0.305</td>
<td>0.305</td>
</tr>
<tr>
<td>Plant and Equipment</td>
<td>2.381</td>
<td>3.068</td>
</tr>
<tr>
<td>Vehicles and Transport Means</td>
<td>0.052</td>
<td>0.206</td>
</tr>
<tr>
<td>Preliminary Expenses</td>
<td>0.210</td>
<td>0.489</td>
</tr>
<tr>
<td><strong>Utilities and Roads</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land improvement</td>
<td>0.051</td>
<td>0.065</td>
</tr>
<tr>
<td>Water</td>
<td>0.123</td>
<td>0.243</td>
</tr>
<tr>
<td>Electric power</td>
<td>0.211</td>
<td>0.445</td>
</tr>
<tr>
<td>Sanitation work</td>
<td>0.266</td>
<td>1.000</td>
</tr>
<tr>
<td><strong>Total Fixed Assets</strong></td>
<td>3.599</td>
<td>5.929</td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>0.500</td>
<td>0.428</td>
</tr>
<tr>
<td>Receivables</td>
<td>1.917</td>
<td>2.182</td>
</tr>
<tr>
<td>Inventories</td>
<td>3.819</td>
<td>4.876</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>9.835</td>
<td>13.415</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity (capital)</td>
<td>3.500</td>
<td>3.500</td>
</tr>
<tr>
<td>H.O.C.</td>
<td></td>
<td>(H.O.S.S.)</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>0.700</td>
<td>(1.976)</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>9.835</td>
<td>13.415</td>
</tr>
</tbody>
</table>

Source: Squibb Egypt’s reports.
regarding the importation of machinery and equipment for
construction of the factory and operation;
4. the lengthy time taken to purchase the land and prepare
it;
5. the absence of a well-structured timetable by the GAFI
for monitoring the execution of the project;
6. the different and conflicting regulations applied by the
government authorities with which the project had to deal.

Returning to the analysis, table 6.2 indicates several
features:
1. Actual total fixed assets amounted to L.E. 5.929 million,
compared with estimates of L.E. 3.599 million. This
considerable increase in capital expenditure on fixed assets
can be attributed to the following reasons:
a) the increase of the amount for each of various elements
of utilities and roads expenses required for the project.
The cost of supplying the site with water, electricity, roads and sewerage, in a remote area with no existing
facilities, proved to be several multiples of the L.E. 0.
600 estimated in the 1974 study. Sanitation works alone cost
Squibb Egypt L.E. 1.0 million because of the need to dispose
of the enormous waste from the processing of chemicals. The
water station and supply of electricity again cost Squibb
more than originally estimated, because of the enormous
quantities of water and electricity required for the
chemicals operations.
b) the increase in the cost of plant and equipment from the
estimated figure of L.E. 2.381 million to the actual figure of L.E. 3.068 million. This was due to the need for various modifications to Squibb Corporation plans. For example, an additional plant for the production of Dexacillin Code No. 97011 and 97512 and Siquil Code No. 92122, 92222, and 92020 (which were not provided for in the original study) was built in order to meet the needs of the local and regional markets.

c) the increase of vehicle and transport costs from L.E. 0.052 million to L.E. 0.206 million, because of a high increase in product distribution.

d) the increase of preliminary expenses from L.E. 0.210 million to L.E. 0.489 million, due to the need to reorganise production processes as a result of the difficulties which arose during the construction period. Because of the large increase in expenditure on fixed assets, the company's management decided to finance this increase by a long-term loan of L.E. 2 million.

2. Actual current assets amounted to L.E. 7.486 million, compared with estimates of L.E. 6.236 million. This increase was attributable to the following reasons:

a) The actual inventories figure was increased by the need to increase production of new drugs. The inventories figure was L.E. 4.876 million, compared with an estimate of L.E. 3.819 million.

b) The actual accounts receivable increased to L.E. 2.182 million, compared with estimates of L.E. 1.917 million, indicating that credit sales were higher than expected.
3. Accounts payable - Intercompany, which are provided by the corporation family as a short-term source of finance, were increased in order to support the high increase in working capital. Their actual balance was L.E. 7.028 million, compared with estimates of L.E. 3.249 million. This sharp increase is partly to make it easier for the subsidiary to expand its share and influence in the local market and partly to allow it to transfer funds quickly by the use of transfer pricing practices. In fact, funding from the Squibb Corporation family provides three distinct advantages, all concerning flexibility. These are:

- flexibility over the timing of transfers. This means that intercompany transfers give Squibb ability to time payments so as to take full advantage of Egyptian exchange rate movements.

- flexibility over the direction of transfers, e.g. it may be sensible to direct funds flows from Squibb Egypt to another subsidiary rather than to the head office to reduce limitations on remittance.

- flexibility over the type and scale of transfers, e.g. it is not easy to determine the market value of raw materials, etc.

4. A final point revealed by the analysis and comparison of the project's balance sheet is that the project made losses in the first year of operation. This loss was due partly to corporation policy and partly to price control and the devaluation of the Egyptian pound against the dollar from
$=L.E. 0.65 to $=L.E. 0.70 in 1979. In the light of this analysis, it is argued that the project needed careful attention by the government evaluators using eco-accounting techniques, and accurate monitoring and control, in order to avoid the serious problems which it has recently caused to the national economy (see chapter 9 and 10).

6.4.1.3 Operating Costs and Revenues

Squibb Egypt has made large and sustained losses since its establishment in 1979. Table 6.3 shows the difference between the estimated and actual profit in the first year of production and in 1983.

It can be seen that the estimated profit for the first year of the project was L.E. 0.700 million, i.e. 6.7% of the value of output. However, the same table shows that the subsidiary actually made a loss of L.E. 1.976 million, i.e. (20.3%) of the value of output. By 1983, the loss had increased to L.E. 5.768 million, i.e. (42.7%) of the value of output. The devaluation of the Egyptian pound against the dollar affected both costs and selling prices. In particular, the dependence on raw materials imported from the parent company raised costs of production. In addition, the drug price controls which were imposed by the Egyptian government caused loss of income.

Thus, the project analyst must examine expected revenues from local sales and exports and other income, to assess whether these return the project’s costs and provide the expected rate of return. He should also investigate the expected foreign currency receipts from exports, and their
Table 6.3  
Estimated and Actual Costs and Revenues  
value in L.E. Million

<table>
<thead>
<tr>
<th></th>
<th>1979 Estimated</th>
<th>%</th>
<th>1979 Actual</th>
<th>%</th>
<th>1983 Actual</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of output</td>
<td>10,500</td>
<td>100.0</td>
<td>9,750</td>
<td>100.0</td>
<td>13,500</td>
<td>100.0</td>
</tr>
<tr>
<td>Production Cost</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw materials</td>
<td>6,100</td>
<td>58.1</td>
<td>7,400</td>
<td>75.9</td>
<td>11,600</td>
<td>85.9</td>
</tr>
<tr>
<td>Wages and Salaries</td>
<td>0.631</td>
<td>6.0</td>
<td>0.631</td>
<td>6.5</td>
<td>0.764</td>
<td>5.7</td>
</tr>
<tr>
<td></td>
<td>6.731</td>
<td>64.1</td>
<td>8.031</td>
<td>82.4</td>
<td>12.364</td>
<td>91.6</td>
</tr>
<tr>
<td>Marketing</td>
<td>0.437</td>
<td>4.2</td>
<td>0.510</td>
<td>5.3</td>
<td>0.679</td>
<td>5.0</td>
</tr>
<tr>
<td>Administration &amp;</td>
<td>0.190</td>
<td>1.8</td>
<td>0.210</td>
<td>2.1</td>
<td>0.271</td>
<td>2.0</td>
</tr>
<tr>
<td>general</td>
<td>0.627</td>
<td>5.9</td>
<td>0.720</td>
<td>7.4</td>
<td>0.950</td>
<td>7.0</td>
</tr>
<tr>
<td>Other expenses</td>
<td>2.442</td>
<td>23.3</td>
<td>2.975</td>
<td>30.5</td>
<td>5.954</td>
<td>44.1</td>
</tr>
<tr>
<td>Total cost</td>
<td>9.800</td>
<td>93.3</td>
<td>11.726</td>
<td>120.3</td>
<td>19.268</td>
<td>142.7</td>
</tr>
<tr>
<td>Annual Profit (loss)</td>
<td>0.700</td>
<td>6.7</td>
<td>(1,976)</td>
<td>(20.3)</td>
<td>(5,768)</td>
<td>(42.7)</td>
</tr>
</tbody>
</table>

Source: Figures obtained at Squibb Egypt, 1987

influence on the balance of payments.

Also, costs must be precisely investigated, especially those of raw materials and overheads. In fact, the statement of estimated and actual costs and revenues includes the cost of raw materials, labour, marketing and administration, and other expenses which include foreign exchange and interest. Each of these factors will be considered separately.

6.4.1.3.1 Cost of Raw Materials

The costs of raw materials are classified into two groups: materials imported from within the corporation and
those obtained in the local market. In the case of Squibb, the policy of the parent company is that 90% of the total raw materials used in production should be imported from within the corporation. However in practice, the actual percentage varies from year to year due to changes in its inventory policy (see chapter 9). For example, the percentage of imported raw materials cost to total raw materials used in production was 80.2% in 1987, and 80.3%, and 79.9%, and 85.1 in 1986, 1985 and 1979 respectively (see table 5.3).

In fact, a great number of raw materials, particularly chemicals, are required for pharmaceutical production at Squibb Egypt. Most of these are not available locally. The estimated prices of these raw materials are calculated according to the prevailing international prices without allowing for customs charges. The customs rate charged at Alexandria is 5 percent plus L.E. 68 per ton for transport to Squibb Egypt's plant. In addition, the costs of most local raw materials increased by 30%, although many of these were extremely low in price by international standards. Such items included cartons, packaging and stationery.

A comparison of the actual costs of raw materials in 1979 with the costs estimated in the feasibility study, in table 6.3 shows that, while the estimated ratio of raw materials cost to value of output was 58.1 percent, the actual ratio was 75.9 percent, which reflected a considerable increase in the total costs of production. By
1983, the actual cost of raw materials had increased to 85.9 percent of the value of output. These differences are due partly to the instability of the general level of prices and fluctuation of exchange rate and partly, as indicated latterly, to the subsidiary’s use of transfer pricing practices to overstate its costs and understate its reported profits (see chapters 7 & 9).

Therefore it is necessary for the government to examine and monitor the price for imported raw materials, to ensure that the prices of subsidiary’s raw materials are confined to international standards. In addition, it is essential to consider price and foreign exchange rate fluctuations in the feasibility study of the project, to prepare reliable indices for costs factors, and to unify the foreign exchange rate.

6.4.1.3.2 Labour Costs

The number of employees in the feasibility study amounted to 229 people, with total wages of L.E. 0.631 million, i.e. 6.0 percent of the value of output for the first year of production. In practice, even though the number of workers increased to 239, labour cost was almost the same as indicated in the feasibility study; almost 6.5% of the value of output. However, by 1983 the total number employed in the plant’s operation was 249, with annual wages and salaries of L.E. 0.764 million, i.e. 5.7 percent of the value of output. It can be seen that although the number of workers and their costs changed very slowly between 1979-1983, there is a decrease in the relative amount of labour.
costs. This was attributable partly to the increase in volume and partly to the corporation's employment policy. Employment policies in Egypt stipulated that each foreign enterprise must employ a labour force containing not less than 75% Egyptian workers, and Squibb was forced to comply with such policies.

Several points emerge from the above discussion, regarding the way in which the labour cost is constructed.

a) Squibb Egypt has little impact on the number of workers employed and their costs. However, it should be noted that the cost of labour employed before the project's establishment was idle capacity. In addition, there is a relationship between the number of workers required and the size of project and its technology. Accordingly, failure to monitor the project's employment could lead to an unsatisfactory impact on Egypt employment.

b) The feasibility study gives the number of workers in total, making no distinction between skilled and unskilled labour. The distinction between skilled and unskilled labour is of great importance in determining a project's costs and benefits.

c) The feasibility study restricted itself to the cost of labour prevailing in the year of the feasibility study, without regard to the expected cost during the life of the project. However, the sound appraisal of any project should consider future costs and benefits during its expected life.

d) The cost of labour does not include only wages and
salaries, but must contain all other benefits provided for workers in the project, such as health services, etc.

It can be concluded the evaluator should investigate the manpower requirements of the project in terms of numbers of employees, wages and salaries, and types of workers and employees, e.g. technical, administrative, whether Egyptian or foreign, skilled or unskilled workers.

6.4.1.3.3 Operating Expenses

The operating expenses of the project are classified into two groups. The first group is marketing and administrative expenses and the second group is general expenses, which includes foreign exchange losses and interest.

A comparison of figures for marketing, administration and other expenses from table 6.3 suggests a relatively large difference between the estimated and actual expenses in the first year of production. It can be seen that while the ratio of estimated marketing and administration expenses for the first year of the project was 5.9 percent of the value of output, the actual ratio was 7.4 percent. This probably happened as a result of the change in the general level of prices and devaluation of the Egyptian pound. By 1983, these expenses had decreased to 7.0 percent as a result of an increase in the volume of output.

The table also shows that the estimated ratio of general expenses to output was 23.3 %, compared with the actual ratio of 30.5 % in the first year of the project. By
1983, these expenses had increased by 44.1 percent. This increase was due mainly to the devaluation of the Egyptian pound and the increase of the amount of short and long-term debts.

On the whole, a comparison of the total estimated costs with the actual costs in 1979 and 1983, shows that, for both years, the total costs output were well above the value of output. This confirms the comment made by a government official that Squibb Egypt's technique for using transfer pricing is extremely efficient (interview with a government official at Organisation of Drugs on 22nd Jan., 1988). In addition, it is surprising that none of the reports exchanged between Squibb Egypt and the General Organisation of Drugs seriously questioned the variance of production costs from those estimated in the feasibility study. This indicates a need for the project monitor to examine these costs and investigate which of them have a negative effect on profit.

In fact, there is a clear difference between financial profit and economic profit. The former is related to the project itself whilst the latter is associated with the net benefit to the country. The former is obtained from output minus costs as seen in table 6.3. However, it may be argued that the figures for output and input are misleading because they are based on private market prices, which give distorted price signals for economic appraisal, and they ignore the timing of gains and costs, so that it is difficult to judge whether or not the project is financially
profitable, given that profit is defined as the surplus from output after deducting the total annual costs, and represents gross profit, since marketing, administrative and general expenses are ignored.

Therefore, it can be argued, from the economic point of view, that the financial profit of a project, which is based on unrealistic figures for costs and revenues, does not constitute a sufficient criterion for its appraisal. The appropriate criterion for a sound project appraisal is economic profit, which reflects the net benefit generated by the project for the country as whole. The starting point for assessing the economic profitability of a project should be to adjust the market price of the project’s output and inputs for an estimate of social prices.

6.4.2 Economic Analysis

In addition to the financial analysis made in the above section, it is important to pay attention to the economic analysis of the feasibility study to reveal the net benefit that was expected to be gained by the country. It was stated that Squibb’s proposal was accepted on the basis that the project would:

1. provide the Egyptian market with locally – produced pharmaceuticals;
2. increase the overall level of employment;
3. utilise available local resources;
4. provide and save foreign currency.

In the light of the above requirements, this section
outlines the economic appraisal operated by the Egyptian government, evaluates its effectiveness, and suggests what changes are required for economic appraisal better to meet national objectives. The measures used in this respect are value added, and balance of payments effects.

6.4.2.1 Value Added Indicator

The method used by the Egyptian government to calculate Squibb's expected value added was based on the Egyptian Uniform Accounting System, which was designed to assist social accounting (see chapter 3).

It can be seen from table 6.4 that the expected gross and net value added of Squibb Egypt was very positive. These figures are based on the value of expected production at selling price less the estimated costs of materials plus

<table>
<thead>
<tr>
<th>Output</th>
<th>10.500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Commodity requirement and service acquired</td>
<td></td>
</tr>
<tr>
<td>Raw materials</td>
<td>6.100</td>
</tr>
<tr>
<td>Packing material</td>
<td>0.350</td>
</tr>
<tr>
<td>Services bought from others</td>
<td>0.650</td>
</tr>
<tr>
<td>(water, electricity, gas etc.)</td>
<td>7.100</td>
</tr>
<tr>
<td>Gross Value Added</td>
<td>3.400</td>
</tr>
<tr>
<td>Less: Depreciation</td>
<td>0.285</td>
</tr>
<tr>
<td>Net local value added</td>
<td>3.115</td>
</tr>
</tbody>
</table>

Source: Organisation of Drugs, "Squibb Egypt's appraisal report", Cairo, 1974
services and depreciation. The sum of the local net value added is estimated at L.E. 3.115 million, calculated as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages and Salaries</td>
<td>0.631</td>
</tr>
<tr>
<td>Profits</td>
<td>0.700</td>
</tr>
<tr>
<td>Others</td>
<td>1.784</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3.115</strong></td>
</tr>
</tbody>
</table>

This suggests that the project should be accepted from the economic point of view, since it concludes that the sum of value added generated will increase to the benefit of net national income.

However, this measure is deceptive, partly because it disregards foreign transactions, (payment of fees, royalties, interest, dividends, etc.) and partly because private market prices do not accurately reflect the social value of outputs and inputs, either because of market distortions or because of government legislation. This means that social prices have to be imputed to domestic inputs and outputs, to reflect the social cost of resources deployed.

With regard to the first aspect, it can be argued that, as long as Squibb Egypt is considered as a foreign project in the Egyptian market, payments to its parent and foreign lenders must then be subtracted from projected output. Thus, the expected local value added can be calculated in the light of the United Nations formula, as explained in chapter 2.

Table 6.5 shows the net local value added, represented in two ways: the estimated value added compared with that of the Uniform Accounting System and the actual value added for
the first year of production in 1979.

It can be seen from the table that the sum of estimated net value added is L.E. 1.768 million as compared with the original estimate of L.E. 3.115 million, while the actual result for the same year is negative, i.e. L.E. (0.948 million). These figures are obtained from the value of output at selling price less imported raw materials,

Table 6.5
Estimated and Actual Value Added for 1979
(Value in L.E. million)

<table>
<thead>
<tr>
<th>Estimated</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>output</td>
<td>10.500</td>
</tr>
<tr>
<td>Less: Input</td>
<td></td>
</tr>
<tr>
<td>Imported raw material (without customer)</td>
<td>6.100</td>
</tr>
<tr>
<td>Packing material</td>
<td>0.350</td>
</tr>
<tr>
<td>Services bought from others</td>
<td>0.650</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Value Added</td>
<td>3.400</td>
</tr>
<tr>
<td>Less: Depreciation</td>
<td>0.285</td>
</tr>
<tr>
<td>Fees</td>
<td>0.022</td>
</tr>
<tr>
<td>Royalties (7.5% of sales)</td>
<td>0.787</td>
</tr>
<tr>
<td>Interest</td>
<td>0.398</td>
</tr>
</tbody>
</table>

Head office remittance profits

\[
\frac{700 \times 20}{100} = 0.140 \quad 1.632 \quad 1.978
\]

Net value added 1.768 (0.948)

packing materials and services acquired, and less payments made to the parent company and foreign lenders. However, as
we have seen, the value of output was exaggerated, the expected prices were unrealistic and the estimates of imported raw materials and other costs were unreliable. In view of these circumstances, the project should have been rejected from the point of view of economic analysis. In addition, it can be seen that the actual value of interest charged was high compared with budgeted. This high rate of interest may be attributed to the increased cost of capital, due to the high rate of commission and services charged, and to inflation. Therefore, figures represented in the above table are misleading since they were based on private market price.

Therefore the feasibility study was unrealistic and more attention should have been paid to social costs and benefits.

The economic desirability of the project should thus have been valued in the light of the following factors:

6.4.2.1.1 Valuation of Output

Because the market price is distorted, the government agency responsible for evaluating the proposal should first attempt to adjust the prices of output. To do that, the value of the output should be no higher than the price of the cheapest alternative source from which the product could be obtained in the absence of the project. The inputs should be priced at the value they would yield elsewhere in the economy. The best measure, in this case, is the price on the international market. Thus, a modification should be made to reflect imperfections in the exchange rate for the Egyptian
currency. In this case, the value of output and inputs need to be recalculated using shadow prices for foreign exchange. If the international price is below the projected prices that appear in the private statement of the project, the project will be unprofitable from the social point of view. This is due to inefficient use of resources.

However, if the outputs of the project were viewed as avoidance of future increases in imports or of export orientation, careful attention should be given in the feasibility study to the capacity of the project's foreign exchange earnings. This is because the main objective of the project in this respect is to earn or save foreign exchange.

6.4.2.1.2 Valuation of Input

Since all costs and benefits in economic analysis have to be valued on the same basis, the project inputs have to be treated in the same way as the project output. On the input side, the costs of the projects are usually broken down into traded and untraded components in order to help decision-makers.

6.4.2.1.2.1 Valuation of Traded Input Items

The project costs, which are classified into capital and operating costs, mainly consist of property, plant and equipment, vehicles, direct raw materials and other materials and supplies that are imported or domestically produced. These items represent a large proportion of total costs and are expressed directly at international prices.
(CIF prices at the official exchange rate)*. To evaluate these items from the economic standpoint, it is necessary to establish the relationship between the international and the domestic price. The economic value of a traded item is its import value, which is derived by adjusting the CIF price to allow for the premium on foreign exchange arising from distortions caused by trade policies. This premium is inadequately reflected when the prices of traded items are converted to domestic currency at the official exchange rate. Therefore, the value of traded items must be expressed in foreign exchange by the use of a shadow exchange rate, which is derived by multiplying the official exchange rate by the foreign exchange premium. If allowance is made for an overvalued exchange rate in the case study, the project looks better, since the value of the imported input is less than the value of the output at international prices.

6.4.2.1.2.2 Valuation of Non-Traded Input Items

Non-traded items are defined as those inputs of the project which are not traded across the national boundaries of the country concerned, because of their cost of production or because of restrictive trade practices (Gittinger, 1982, p. 488). Examples of these items in our case study are labour, electricity, water, etc, whose market prices have to be adjusted for price distortions in order to reflect their economic values. In fact, if these domestic inputs bear indirect taxes or subsidies, these must be

* The official exchange rate used for the calculation of these items was $1 = L.E. 0.70.
deducted from the price of the product, according to the principle that transfer payments in the economy are not counted.

Accordingly, a conversion factor* can be used to eliminate the difference between the general level of internal prices and that of comparable international prices if the market price of an item is to be a good estimate of its opportunity cost. Otherwise it is necessary to adjust the prices to eliminate market distortions, after which they should be multiplied by the conversion factor in order to obtain the economic values.

As far as labour is concerned, the appraiser should distinguish between skilled and unskilled labour. In Egypt, skilled labour is usually fully employed. In this case, it is reasonable to charge the project with the full market cost of skilled labour, which is assumed to provide a satisfactory measure of the opportunity cost of this type of labour in its alternative use.

With regard to unskilled labour, the appraiser should examine the sources from which it is drawn. First, if the project uses unskilled workers who were jobless, labour should be valued at zero opportunity cost because it would yield nothing for the economy unless it were used in the

* A conversion factor (CF) represents the ratio of the shadow price or value in terms of foreign exchange to domestic market price. In other words, it represents the inverse of one plus the effective duty or subsidy rate, i.e. (Ray, 1984, p.51),

\[ \text{CF} = \frac{1}{\text{domestic price} + t} \]

Where \( t \) is equal to (- duty rate) or (+subsidy rate).
project. Second, if the project uses unskilled labour drawn from other sectors or the same sector in the economy, the shadow wage rate should be employed to measure what would be foregone elsewhere in the economy as a result of withdrawing workers from their current activities.

6.4.2.1.2.3 Valuation of Transfer Items

Contradiction often arises between the financial and economic analyses over the issue of taxes and subsidies. In financial analysis, tax payments are basically a cost item, while subsidies represent a benefit to the project. These items are not included in the financial analysis or elsewhere in the feasibility study. However, they are treated from the economic point of view as transfer payments, since one part of the economy would be adversely affected by the amount of tax, whilst another part would benefit. Therefore, payments and benefits should be excluded from the economic calculation.

In addition, some other items, such as interest on capital and depreciation included as costs in the financial calculation are transfer payments, and should be omitted from the economic calculation.

The interest is not the real cost to the economy of all capital, but only a market price for the portion borrowed. In considering the social benefits for society, this item should not be included as a cost, since the main objective of the study is to measure the social profitability of the project.
Depreciation is generally acknowledged to be a transfer of funds from one account to another within a project. It appears in the income statement as an expense item and in the balance sheet as a transfer from capital assets to liquid assets. It does not represent an actual cash flow since no money physically leaves the project. Depreciation does not represent a direct claim on a country's resources and no allowance need be made for it in the sense used by accountants. Thus it should be excluded from the economic appraisal of the project.

Based on the above modification of the financial figures for the purpose of economic appraisal, the analyst should put together these figures for a number of years into the future and discount them to yield the present value for the costs and benefits of the project to society. The timing of the costs and benefits, and risk and uncertainty should be taken into consideration because they affect the calculation of present value.

It can be concluded from the above discussion of financial and economic appraisal that the project analyst should first identify, and then value the costs and benefits over the project's life. He should then compare the project's costs with its benefits to measure how much benefit the project will provide to society. However, there are major differences between financial and economic analysis in determining the net benefit of a project to the economy:

1. Financial analysis is concerned with the maximisation of
private profit of projects whilst economic analysis is related to social cost-benefit analysis, which seeks maximisation of social benefits over costs.

2. Financial analysis of private projects does not take external effects into account, whether they are costs or benefits. These should be included where the project is being evaluated from the social point of view. The social cost can be classified in two groups:

(a) direct social costs - which include society's resources such as land, employment, foreign exchange, etc., judged on an opportunity cost basis;

(b) indirect social costs - which may be divided into tangible and intangible costs. The tangible costs are concerned with the extent of the project's influence upon balance of payments and the like, while the intangible costs refer to the project's negative effects on society in such areas as pollution etc.

3. Financial analysis is based on market prices, which may often distort the economic analysis. Therefore, another price should be taken to reflect the real costs and benefits from the economic/social point of view.

4. Financial analysis uses the cost of capital as a rate of discount, whilst economic/social analysis uses the social discount rate as an indicator for investment decisions from the national point of view.

5. Financial analysis uses cash to measure benefits and costs, but economic analysis relies upon cash and non-cash
elements to reflect national objectives.

6. Financial analysis concentrates on the revenues and expenses of the project without taking account of various national objectives, such as balance of payments, employment, the growth of national income etc. For example, taxes are treated as a transfer payment when economic/social benefit analysis is considered, whereas they are charged in the income statement as an expense in financial analysis.

It can be argued that project appraisal requires an examination not only of the project itself, but also of all the circumstances surrounding it, to ascertain whether it allows for reasonable economic and financial benefit. The feasibility study of a project should therefore be examined from various point of view - technical, financial and social - by the Central Agency for Auditing, in order to determine exactly what net benefit a project will provide for the country.

In spite of the importance of financial and economic analyses, they cannot answer all the questions regarding the project appraisal. They are unable to answer, for example, questions about job creation, balance of payment effects and the like.

6.4.2.2 Balance of Payment effects

The indicator adopted here to measure a project's economic profitability is the effect of a project on the balance of payments in terms of foreign exchange reserves and export promotion and import - substitution. With regard the first effect, figure 6.2 shows the pattern of the
foreign exchange budget which should be presented by Squibb Egypt.

**Figure 6.2**
**Expected Foreign Exchange Budget**

<table>
<thead>
<tr>
<th>Capital</th>
<th>**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>**</td>
</tr>
<tr>
<td>Foreign currency revenues</td>
<td>**</td>
</tr>
<tr>
<td>Local sales</td>
<td>**</td>
</tr>
<tr>
<td>Foreign export</td>
<td>**</td>
</tr>
<tr>
<td>(-)</td>
<td></td>
</tr>
</tbody>
</table>

**Foreign currency expenses**

| Payment loans interest   | *   |
| Depreciation            | *   |
| Raw Material            | *   |
| Fees and Royalties      | *   |
| Others                  | *   |
| Surplus (deficit)       | *   |

The project should make an appropriate contribution to the foreign exchange reserves. If it does not, then it should be rejected.

Analysing the project in question, it can be seen from table 6.6 that the expected total receipt of foreign currency was estimated at L.E. 14.040 million, against L.E. 7.732 million expenditure. The expected net contribution to foreign exchange earnings amounted to L.E. 6.308 million.

The result is favourable, and the project satisfies this criterion because the estimate of foreign currency inflow and outflow was realistic. However, in practice, the result was harmful to the economy (see chapter 10).

With regard the second effect of the balance of payment, the appraiser approved the project in terms of export-orientation and import-substitution criteria, for two
reasons. Firstly it would reduce the amount of drugs imported, and as a consequence, the foreign currency saved from importation could be directed to other public investments. Secondly the exports expected according to the feasibility study would, if realised, have reduced the balance of payments deficit by L.E. 7.310 million. However, it was found that the net effect of Squibb Egypt on the balance of payments was less favourable (see chapter 10).

6.5 Conclusions

The purpose of this chapter was to examine the entry control devices operated by the Egyptian government over Squibb Egypt.

In the first section, a number of entry objectives were restated in a number of measurement criteria by which Squibb Egypt was examined and evaluated. In the following sections, the process of the project's application was

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**Table 6.6**

Squibb Egyptian Foreign Currency Budget

<table>
<thead>
<tr>
<th>Receipts</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>3.500</td>
</tr>
<tr>
<td>Export revenue</td>
<td>7.310</td>
</tr>
<tr>
<td>(75% x 9.750)</td>
<td></td>
</tr>
<tr>
<td>Short - term loans</td>
<td>3.323</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>14.040</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenditure</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw material</td>
<td>6.100</td>
</tr>
<tr>
<td>Fees</td>
<td>0.022</td>
</tr>
<tr>
<td>Royalties</td>
<td>0.787</td>
</tr>
<tr>
<td>Interest</td>
<td>0.398</td>
</tr>
<tr>
<td>Profit remittance</td>
<td>0.140</td>
</tr>
<tr>
<td>Depreciation</td>
<td>0.285 7.732</td>
</tr>
<tr>
<td><strong>Surplus</strong></td>
<td><strong>6.308</strong></td>
</tr>
</tbody>
</table>

Source: Squibb Egypt’s feasibility study.
described. The decision to accept the project was undertaken based on financial and economic analysis. In addition, the technical views of other agencies involved in the examination were also frequently considered by the project evaluation committee of the Ministry of Health.

However, two main observations can be made in relation to the way in which the Squibb Egypt project was accepted. Firstly, the financial analysis indicated that the project would be financially harmful, with a negative influence on the balance of payments and government revenue as a whole. In addition, economic analysis of the project shows that the adoption of the local value added in its current form results in unsound analysis, and hence makes it difficult to measure the project's economic profitability. Moreover, the lack of experience of the evaluators, and the control system itself result in failure to take correct approval decisions.

It is necessary, therefore, that the feasibility study of a project should be examined by suitably experienced staff, such as the Central Agency for Auditing in order to reach a sound project appraisal at the entry stage.

The project appraisal in this case should be based on cost-benefit analysis to judge whether the project would be economically and financially beneficial. In addition, a technical and social analysis would also be a significant tool to answer questions about the impact of the project on the environment and the transfer of technology. The investigation of these aspects is an important task of the feasibility study.
Chapter VII

Financial Control Devices

7.1 Introduction

At the operating stage, the process of control is classified into two main categories, namely financial and administrative controls. For each, a particular follow-up process is operated. The next chapter is devoted to administrative control devices. However, this chapter deals with the financial control process currently operated by the Egyptian government in accordance with the code of foreign investment, to follow up the operation of Squibb-Egypt.

Specifically, this chapter aims to identify what the process looks like, how it operates, what problems and difficulties are associated with implementing it, and what further control devices are required in order better to meet the national interest.

The chapter is therefore divided into three main sections. The first section discusses the process of disclosure of information associated with Squibb's operation. The second section examines the financial audit process which is carried out in order to determine the amount of transferable profits, and related accounting issues are discussed. The final section is concerned with the process operated by the Tax Administration to determine the income tax liability of the subsidiary.

7.2 Disclosure of Information

As far as financial control at the national level is
concerned, Squibb Egypt is required, in accordance with Law 43 of 1974, to disclose information regarding its activities every year, in end of year reports, to be submitted to the GAFI, GCA, GOD and Tax Administration, together with the following documents (Article 3/2):

- Copy of the balance sheet, the profit and loss account, and the auditor's report.
- Names and nationalities of the managers.
- The number of workers, the positions occupied by them, their nationalities and the total payroll, specifying the wages of the Egyptian workers in the company.
- Profits realised and the share of the workers.
- Capital and operations accounts in a foreign currency.

This information can best be obtained through the subsidiary's accounting system. Squibb Egypt keeps full account books regarding the results of its operations, and the accounting system of the corporation was designed in accordance with generally accepted accounting principles (GAAP) in the U.S.A.

Accordingly, there are generally three types of financial statements to be prepared internally in the English and Arabic languages; and monetary values are expressed in U.S dollars and Egyptian pounds respectively. This is due partly to the requirements of the corporation's consolidated reports and partly to the information needs of government authorities for the purpose of determining transferable profits, taxation, monitoring local finance,
and overall evaluation of company performance. The reports are prepared on two levels; the first compares the current year's performance with that of the previous year, while the second compares actual events with the budget forecast for the same year.

All the accounting transactions and auditing are carried out in the finance division of the subsidiary on the basis of data provided by the accounting clerks appointed to the subsidiary. Consequently, this division has on several occasions been asked by government officials (e.g. Tax Administration, General Authority for Foreign Investment etc.) for assistance in dealing with financial reports and problems relating to performance evaluation, because of conflict in the accounting policies being used.

7.3 Auditing

Two types of auditing of the subsidiary's activities are carried out. The first is internal audit, carried out in order to ensure that expenditure and revenues are properly recorded. This is done by both the internal auditing division of the subsidiary and the Department of Auditing of the Head Office.

The second type is external audit. Two such audits are carried out. The first is performed by Peat Marwick Goerdeler, an independent public accounting company. However, Peat Marwick Goerdeler Co., always appoint Mr. H.Z. Hassan as external auditor in Egypt to examine the subsidiary's accounts and prepare a report on the fairness
of the financial statements presentation. This audit is carried out according to general accepting auditing standards.

The second external audit is the government audit. It is common for the government authority to appoint the Central Agency for Auditing to examine the accounts of foreign enterprises which exist as joint ventures with the public sector. However, in the case of Squibb Egypt, which is a wholly foreign-owned subsidiary, this agency is not involved. Nevertheless, by virtue of Law 43 of 1974, the GAFI, GOD, and Tax Administration have the right of access to the subsidiary's books to investigate its reports, in order to:

1. determine the amount of transferable profits,
2. evaluate company performance,
3. determine the amount of the income tax charge,
4. control selling prices.

7.4 Financial Audit Process

The process of monitoring Squibb Egypt's operation undertaken by GAFI is mainly aimed at determining the amount of transferable profits, and evaluating company performance. For each of these aspects a particular monitoring process is operated. This section is devoted to the first aspect, while the process for evaluating company performance is discussed later in chapters 9 and 10.

In the audit process operated by the Follow-Up and Auditing Division (FUAD) at the GAFI, two interrelated
stages can be distinguished: the comparison of actual with expected performance and determination and approval of the amount of funds that should be transferred.

The investigation of the actual performance of the subsidiary is carried out with the following aims:
- ascertaining that the subsidiary's budget is carried out as approved by the Authority's Board of Directors;
- confirming that all costs which pertain to revenues in the income statement are deducted, and the net result has been properly calculated in accordance with generally accepted accounting principles and in the light of the uniform accounting system;
- confirming that the balance sheet shows the financial position in accordance with established accounting rules;
- ascertaining that the subsidiary has discharged all its financial obligations to creditors and the State;
- ascertaining that the original capital has been completely paid in accordance with the agreement and registered with the GAFI;
- ascertaining that the utilisation of foreign currency accounts is in compliance with the purposes set forth in the code of foreign investment and its feasibility study;
- confirming that the documents which reflect the subsidiary's transferable funds are complete and correct;
- ensuring that the subsidiary's foreign obligations are paid through its operating account in foreign currency at its registered bank and at the time determined;
- approving all sales or disposal of capital assets;
- ensuring that the level of export determined in the feasibility study is achieved;
- satisfying itself that the national objectives intended to be achieved by the subsidiary are being met;
- reporting to the Authority Board, setting forth the auditing process operated by the GAFI's staff for determining the funds to be repatriated, and evaluating the subsidiary's performance.

However, several problems arise in the auditing process undertaken by FUAD, due to the differences between the accounting systems used by Squibb and the EUAS. The major differences between the accounting systems of Squibb and Egyptian Uniform Accounting System (EUAS) can be observed in the following areas:

1. Disclosure

Under the EUAS, six financial statements must be prepared and disclosed in order to assist in the process of national planning and control at macro level and to satisfy the enterprise's management needs at micro level. These statements are the balance sheet, current operations account, statement of sources and uses of funds, cash flow statement, production and trading account, and profit and loss account.

Under Squibb's accounting system, three main financial reports, as previously mentioned, are prepared and disclosed in order to serve management and investors and to satisfy the requirements of Egyptian government officials.
2. Inventories valuation

Under Squibb's accounting system, inventories are stated at either cost or market price, whichever is lower. The predominant method of inventory valuation is First In First Out (FIFO) which is not acceptable to government officials and is not used.

Under the EUAS, the rules for valuation of inventory valuation are as follows:
- Raw materials are valued and stated at cost. The predominant method used for inventory cost-flow valuation is average cost.
- Semi-finished product is valued and stated at cost of production.
- Finished product manufactured by the entity is valued at cost for financial accounting purposes (at micro level), and at market price for national accounts (macro level). In this context, opposite twin accounts have been established, namely, variances of inventory valuation of sales to reflect the difference between cost and selling price of finished goods in the two sides of current operations account and the balance sheet of the entity.

3. Fixed Assets Revaluation and Depreciation

Under Squibb's accounting system, fixed assets are stated at cost. Expenditures for replacement are capitalised, and the replacement items are retired. Maintenance and repairs are charged to operations. Gains and losses from the sale of fixed assets are included in income.
Depreciation is calculated on the straight-line principle over the estimated useful life of the assets. Land is never depreciated. The percentages for depreciation charges for assets are 2% for buildings, 6.5% for machinery, 25% for vehicles, 10% for furniture and 25% for land improvement. The total amount of these charges is debited to the income statement. Squibb's balance sheet shows depreciation as a deduction from fixed assets.

Under the EUAS, fixed assets are reported based on their historical cost. However, the system requires that replacement cost should be considered by an entity in order to maintain the invested capital. Therefore, an account has been created to treat this problem. This account represents a reserve for appreciation in the value of assets, which needs to be established before the distribution of surplus at 5%, and reported under the reserves section on the liability side of the balance sheet. Another important feature of the EUAS is that capital assets produced for internal use are valued at cost of production, and the current operating account is credited with the cost.

Depreciation is calculated on the straight-line basis. The depreciation charges for assets in the pharmaceutical sector are 3% for buildings, 7% for machinery and equipment, 20% for vehicles, and 6% for furniture. Assets that are already fully depreciated and still in use are depreciated at 50% of the original rate of depreciation and the amount credited to appropriations for the increase in assets' prices.
4. Capitalisation of R & D costs and Project Under Constructions Costs

Research and development costs must be written off in the year incurred, in the Squibb’s accounting system, but costs of projects under construction must be capitalised as fixed assets and must be depreciated within five years.

5. Foreign Currency Translations

Under Squibb’s accounting system, all assets and liabilities of the subsidiary are translated at year-end exchange rates and the resulting adjustments are accumulated in shareholders’ equity. Income and expenses are translated at exchange rates prevailing during the year. Foreign currency transaction gains and losses are included in net income, except for those relating to inter company transactions of a long-term investment nature which are accumulated in shareholders’ equity. This treatment is consistent with the U.S.A. accounting system.

In contrast, accounting practices in Egypt treat foreign currency translation and valuation gain or loss in various ways:

1. According to the Central Agency for Auditing’s decree No. 417 of 1986, an entity’s long-term liabilities, created in foreign currency to finance fixed assets and inventory, must be revalued at the year end using the current exchange rate. The revaluation adjustment resulting from the revaluation of fixed assets is charged to them and depreciated over the estimated useful life of the assets. The revaluation adjustments resulting from the revaluation of long-term
investment and inventories are charged to a "Foreign Currency Fluctuation Account" created for this purpose. The current operating account is then debited/credited with the balance.

2. According to the GAFI's regulation No. 1 of 1986, fixed assets, equity and long-term liabilities of a foreign enterprise should be revalued according to the historical exchange rate at the end of each year in order to reflect objective costs, while working capital should be revalued using the current exchange rate. The revaluation adjustment resulting from the revaluation of working capital is reported as an expense in the enterprise's income statement in the case of a loss, but in the case of a gain, it is included in a separate account, "Foreign Exchange Valuation Allowance".

3. According to the Egyptian Central Bank's regulations, all assets and liabilities are revalued at the year end using the current rate. Any exchange loss arising from the translation process is included in the income statement, usually under other expenses. By contrast, any exchange gain arising from translation is recorded in an account for "Foreign Currency Differences Reserve".

4. According to the Tax Administration's regulation No. 1 of 1985 and No. 40 of 1987, fixed assets, equity and long-term liabilities should not be revalued at the end of each year, while working capital must be revalued, using the current exchange rate. Revaluation adjustment losses arising from
revaluation of working capital are reported as expenses in the income statement, but, if the result is a gain, then it is reported as real revenue in the income statement during the year of revaluation.

As for transactions, it was accepted by all sides that gains or losses arising from any transaction between Squibb Egypt and its fellow subsidiaries or third parties must be recognised in the income statement.

It can thus be seen that Squibb Egypt prepares financial reports under different requirements, and for different purposes. For local disclosure, Squibb Egypt is left free to submit reports to GAFI according to its own accounting system. However, during the application of the process to determine funds remittance, taxation, and evaluate company performance, diverse accounting policies distort the reported figures. For example, the different depreciation methods used will cause differences in the resulting ratios. Therefore, the subsidiary should be asked to follow Egyptian accounting policies in such a way as to meet the country’s objectives. The danger here, as explained by the financial manager of the company, is that Squibb sees this set of policies as a burdensome nuisance which has little, if any, value for the subsidiary. Nevertheless, Egyptian government authorities should take care to control company practices which constitute a threat to their sovereignty.

7.4.1 Control of Transferable Funds

Squibb Egypt has the right, through the Code of Foreign
Investment, to transfer 20% of its net generated profits, royalties, and management fees at the highest prevailing rate declared for freely convertible foreign currency within the limits approved by the GAFI and subject to the foreign currency acquired by it. In this respect, the government makes efforts to ensure that profits are earned through the activities of the subsidiary. This section therefore identifies the processes operated and the problems that may occur in this respect.

7.4.1.1 Profit Remittance

Squibb Egypt is assumed to be profitable according to the rate of return given in the feasibility study and is allowed to transfer 20% of its annual net profit to its head office *. However, the results of its operation have shown large and sustained losses throughout the 1980s, although the revenue has increased and the financial position has improved (see chapter 9). This is due partly to internal factors such as transfer pricing practices and partly to external factors such as general policies and regulations applied by the Egyptian government and other environmental factors such as inflation, etc. In this context, the financial manager explained the position as follows (Interview on 31st Jan., 1988):

"In operational terms our company continues to operate well. The investment policy which is so vital for the future is being launched according to plan and we still maintain our position in the pharmaceutical industry in Egypt. Despite all this, the company always shows

* The procedure for determining transferable profits is fully shown in chapter 4.
a loss at the end of each financial year, starting from the date of operation. The reasons are actually attributable to several factors: the dominant price control by the government, reduction in export volume as a result of the Arab boycott, multiple exchange rates, inflation, and the shortage of foreign exchange resources in the light of the prevailing economic condition".

7.4.1.1.1 Export Difficulties

Squibb Egypt's factory was intended to export 75% of its production to supply the Arab and Middle Eastern countries, and some others. However, the boycott of Egypt by the Arab countries, from 1978 to the end of 1987, caused the failure of this prediction. The Arab and Middle East markets represent about 85% of the subsidiary's exports and the balance is made up of exports to African and European countries. Since exports are largely unpredictable, sales are based on the Egyptian market only. This has led to a reduction in the subsidiary's revenue as result of the lower net ex-plant prices in the local market, and decreased foreign currency flows over the years in operation. If the intended export percentage had been achieved, then the revenue forgone would be earned and the losses would not have occurred.

The correct yardstick of the revenue forgone is that a comparison should be made between domestic sales and the amount assumed to be earned from exports. Accordingly, the revenue forgone can be measured in terms of the following equation:
The export revenue forgone = weighted average of sales assumed to be exported \( \times \) shadow foreign exchange rate - domestic sales

Weighted average = \( \frac{(D)_i \times \text{Specified price index}}{(N)_i \times 100} \)

where:
- \((D)_i\) sales of the selected period
- \((N)_i\) number of years
- \(\text{SER}=\) official exchange rate \(\times\) foreign exchange premium.

Thus, the above equation provides a yardstick for measuring the real value of revenue forgone that can be generated by the subsidiary's exports.

### 7.4.1.1.2 Foreign Exchange

The continuing devaluation of the Egyptian pound against the U.S. Dollar, together with multiple exchange rates is a vexing problem (see chapter 3), affecting the results of Squibb Egypt's operations. In this context the financial manager stated that (Interview on 7th Jan., 1988):

"The devaluation of the Egyptian pound against U.S. dollar, together with employing a number of exchange rates, have affected the subsidiary's operating results in relation to recording of transactions, and valuation of assets and liabilities. At least four exchange rates can be used and distinguished by our subsidiary. The first is the historical rate which is the exchange rate prevailing at the date of assets acquisition or liabilities incurrence. The second is the current rate, which is the exchange rate prevailing at the time of preparing financial statements. The third is the accounting rate, which is an average historical rate used for recording the subsidiary's transactions during the period. This rate varies by three percent as compared with the historical exchange rate. Our subsidiary uses the latter rate to preserve the original cost equivalent of U.S. dollar currency items in domestic currency.
statements. The final exchange rate is the free market rate which is sometimes used by us, if there are shortages of foreign currency available for purchasing goods and/or paying debts. This rate refers to the daily rate used in the Egyptian market, which is not permitted to be used by companies. This is based on international market exchange rates and supply and demand, and is only for public use. Thus, financial statements cannot be prepared with reasonable accuracy, unless the foreign exchange differences in their different forms are identified and recorded properly."

On the basis of the foregoing, foreign exchange is undoubtedly a highly problematic issue; it has two interrelated dimensions, namely, accounting and taxation. This section discusses the first dimension, illustrating the accounting procedures for translation of Squibb Egypt’s financial statements and for recording and reporting its foreign transactions and how adjustment is carried out.

7.4.1.1.2.1 Translation Adjustment gain or loss

The translation of Squibb Egypt’s financial statements into U.S dollars involves two key issues: the exchange rate at which various accounts are translated from the Egyptian pound to the U.S. dollar and how the resulting translation gains or losses are to be recognised in the reports. All Squibb’s assets and liabilities are translated into the parent’s reports using the current rate method. The shareholder’s equity accounts are translated using the historical exchange rate. Subsequently, the foreign exchange differences arising from translation, accumulated in the shareholder’s equity on the basis of these differences, are unrealised. The objectives of this treatment, as stated in
FASB 52, are to:

1. Provide information that is generally compatible with the exposed economic effects of an exchange on an enterprise's cash flows and equity [par. 4 (a)].

2. Reflect in consolidated statements the financial results and relationships of the individual consolidated entities as measured in their functional currencies in conformity with U.S. generally accepted accounting principles.

In addition, FASB 52 has a special provision for translating financial statements of subsidiaries of U.S. companies in countries where cumulative inflation has been approximately 100% or more over a three-year period. Financial statements of these subsidiaries must be translated into the reporting currency using the monetary/nonmonetary method of FASB 8. In this context, the financial manager stated during interview on 19th Jan., 1988, that

"Our subsidiary uses the current rate method for the translation of financial statements. This is because Egyptian inflation rates are normally less than the concept of inflation rate embodied in FASB 8."

With regard to the income statement, all revenue and expenses accounts are translated at the average exchange rate calculated by the subsidiary's management for the period.

Tables 7.1 and 7.2 show the translation of Squibb Egypt's balance sheet at November, 30, 1985, and the statement of income for the year ended November, 30, 1985, as examples for the purpose of this study.
Table 7.1 shows that all revenues and expenses in the subsidiary's income statement are translated at the average rate $1=L.E. 0.97 in effect during the 1985 year. This process led to net loss translated into dollars of $15.806 million and to year-end retained earnings of $25.370 million.

The balance sheet at November 30, 1985 of Squibb Egypt appears in the first column of table 7.2. The second column depicts the U.S. Dollar equivalents of the Egyptian pound when the exchange rate was $1 = L.E. 0.83. The third column of the balance sheet shows that the Egyptian pound was actually devalued by more than 62% i.e. ($1 = L.E. 1.35) in 1985. This devaluation was a result of the Ministerial Decree No. 167, issued by the Ministry of Economics and Foreign Trade in April, 1985, to reform the Egyptian pound in relation to the dollar.

Table 7.2 indicates the translation procedure using the current rate method. Under this method, assets and liabilities on the predevaluation balance sheet are translated at the current rate of L.E. 0.83/$. Capital stock is translated at the historic rate of L.E. 0.70/$ and L.E. 0.83/$, and retained earnings are translated at a composite rate that would be equivalent to having the additions to retained earnings of each past year translated at the exchange rate in effect in that year.

As shown in table 7.2, the "before-devaluation" dollar translation shows an accumulated translation loss from prior
periods of $ 1.397. This balance is the cumulative gain and loss from translating L.E. statements into dollars in prior periods.

Table 7.1
Squibb Egypt
Translated Income Statement
For the Year Ended November 30, 1985

<table>
<thead>
<tr>
<th>Value in L.E. &amp; $ million</th>
<th>L.E.</th>
<th>Exchange rate</th>
<th>U.S. Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>29.389</td>
<td>0.97*</td>
<td>28.507</td>
</tr>
<tr>
<td>Direct Cost of Sales:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Raw Material</td>
<td>27.454</td>
<td>0.97</td>
<td>26.630</td>
</tr>
<tr>
<td>- Labour</td>
<td>1.507</td>
<td>0.97</td>
<td>1.462</td>
</tr>
<tr>
<td>Gross Profit (Loss)</td>
<td>0.428</td>
<td></td>
<td>0.415</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Marketing</td>
<td>1.722</td>
<td>0.97</td>
<td>1.670</td>
</tr>
<tr>
<td>- Administrative</td>
<td>0.605</td>
<td>0.97</td>
<td>0.587</td>
</tr>
<tr>
<td>Operating profit</td>
<td>(1.899)</td>
<td></td>
<td>(1.842)</td>
</tr>
<tr>
<td>Other Income</td>
<td>1.761</td>
<td>0.97</td>
<td>1.708</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>(0.138)</td>
<td></td>
<td>(0.034)</td>
</tr>
<tr>
<td>Foreign exchange</td>
<td>15.202</td>
<td>0.97</td>
<td>14.746</td>
</tr>
<tr>
<td>Interest</td>
<td>0.821</td>
<td>0.97</td>
<td>0.796</td>
</tr>
<tr>
<td>Other</td>
<td>0.134</td>
<td>0.97</td>
<td>0.130</td>
</tr>
<tr>
<td>Net Profit (Loss)</td>
<td>(16.295)</td>
<td>0.97</td>
<td>(15.806)</td>
</tr>
<tr>
<td>Retained earnings, Nov.30, 1984</td>
<td>(16.447)</td>
<td></td>
<td>(9.564)</td>
</tr>
<tr>
<td>Retained earnings, Nov.30, 1985</td>
<td>(32.742)</td>
<td></td>
<td>(25.370)</td>
</tr>
</tbody>
</table>

* Average exchange rate for current year.
Table 7.2  
Squibb Egypt Translated Balance Sheet  
November 30, 1985*  
Value in $ & L.E Million

<table>
<thead>
<tr>
<th></th>
<th>(1) L.E. Value before L.E.</th>
<th>(2) U.S. Dollar Value after L.E.</th>
<th>(3) U.S. Dollar Differences</th>
<th>(3 -2) Differences</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>0.050</td>
<td>0.042</td>
<td>0.068</td>
<td>0.026</td>
</tr>
<tr>
<td>Time Deposits</td>
<td>0.543</td>
<td>0.450</td>
<td>0.733</td>
<td>0.283</td>
</tr>
<tr>
<td>Net Receivable</td>
<td>12.987</td>
<td>10.779</td>
<td>17.532</td>
<td>6.753</td>
</tr>
<tr>
<td>Inventories</td>
<td>13.482</td>
<td>11.190</td>
<td>18.200</td>
<td>7.010</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>0.255</td>
<td>0.212</td>
<td>0.344</td>
<td>0.132</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>27.317</td>
<td>22.673</td>
<td>36.877</td>
<td>14.204</td>
</tr>
<tr>
<td><strong>Net fixed assets</strong></td>
<td>5.410</td>
<td>4.490</td>
<td>7.303</td>
<td>2.813</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>32.727</td>
<td>27.163</td>
<td>44.180</td>
<td>17.017</td>
</tr>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>0.516</td>
<td>0.428</td>
<td>0.697</td>
<td>0.269</td>
</tr>
<tr>
<td>Notes payable</td>
<td>0.160</td>
<td>0.133</td>
<td>0.216</td>
<td>0.083</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>51.517</td>
<td>42.759</td>
<td>69.547</td>
<td>26.788</td>
</tr>
<tr>
<td>Accruals</td>
<td>0.554</td>
<td>0.460</td>
<td>0.748</td>
<td>0.288</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>52.747</td>
<td>43.780</td>
<td>71.208</td>
<td>27.428</td>
</tr>
<tr>
<td>Long Term Debts</td>
<td>9.290</td>
<td>7.710</td>
<td>12.541</td>
<td>4.831</td>
</tr>
</tbody>
</table>

**Shareholder's Equity**  
Capital Stock 3.147x0.70  
0.285x0.83  
(0.3)  
(H.O.A)  
Retained Earnings 32.742  
(25.037)  
(25.370)  
Accumulated Translation adjustment  
(1.397)  
(16.639)  
Total 32.727  
27.163  
44.180

* The balance sheet items are identical to current methods of translation. We assume that these items are prepared the day after devaluation, to avoid complex calculations.  
* After translation or remeasurement of intercompany payables and receivables, they should be at the same U.S. dollar value and can be eliminated. However, for our purposes, we can ignore this, to avoid complex calculations.
years, and is carried separately in a cumulative translation adjustment account.

After devaluation, assets and liabilities are all translated at the new exchange rate of L.E. 1.35/$. The equity accounts, including retained earnings, are translated just as they were before devaluation; the resulting translation adjustment increases to $ 16.639 million. The increase of $ 15.242 million in the cumulative translation adjustment account is the amount of translation loss measured by the current rate method on the day of devaluation.

The translation losses adjustment can be calculated as follows:

<table>
<thead>
<tr>
<th>Foreign Currency Translation Losses</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Translation adjustment for net assets</td>
<td>17.017</td>
</tr>
<tr>
<td>Less</td>
<td></td>
</tr>
<tr>
<td>- Translation adjustment for liabilities</td>
<td>(27.428 + 4.831) (32.259)</td>
</tr>
</tbody>
</table>

Translation adjustment loss (15.242)

Consequently, the subsidiary treated these differences as a loss accumulated in shareholder's equity according to the head office's foreign currency translation policy. This is because translation losses of this sort are unrealised.

However, the General Authority for Foreign Investment forces the subsidiary to recognise the losses which stem from remeasurement of all foreign currency assets and liabilities in the income statement as expenses; but if
gains occur, they should be recorded as foreign currency allowance to offset the accumulated losses in the next period. Remeasurement is similar to translation in that its goal is to obtain equivalent L.E. values for the subsidiary's accounts.

With regard to revaluation of fixed assets, the GAFI stipulates, as seen earlier, that fixed assets must be valued according to historical exchange rates in order to reflect the objectivity of cost. This method was recommended because the Egyptian pound began to weaken against the dollar as a result of the recent increase in inflation. However, this method is misleading, because revaluation of fixed assets based on the historical rate will not reflect the real value of assets, and depreciation charges will be lower than they would have been if valued at current rates. To this end, it can be suggested that regulation by the Central Agency for Auditing is the appropriate method in order to reflect the real value of fixed assets and depreciation and accurately reflect the reported profit.

In respect of working capital revaluation, Squibb Egypt is forced to revalue its current assets and current liabilities at the current rate on the balance sheet date, recording the currency value differences as expenses in the income statement and creating an allowance for foreign currency differences if there is a gain. This approach is also misleading because of its inconsistency with the measurement of the accounting profit which stipulates that each financial period must be charged with its expenses and
revenues.

7.4.1.1.2.2 Foreign Currency Transactions (gains and losses)

Squibb Egypt depends basically on the corporation family and the international market for supplies of goods and sales of its products. These transactions are denominated in a foreign currency other than the subsidiary's recording currency, i.e. L.E. These transactions include:

1. purchase or sales of goods or services whose prices are stated in a foreign currency.

2. loans payable or receivable in a foreign currency.

For recording and reporting purposes, two types of settlement of these transactions are required. The first is currency value differences, which reflect the difference between the amount originally recorded and the amount presented in the financial statements for payments or receipts. The second is currency value differences, which result from the difference between the rate issued by the GAFI for these transactions (the official rate) and free market rates.

To this end, the subsidiary has to carry out three main accounting steps, as follows:

1. Transaction Date: Record the purchase or sale transaction at L.E. equivalent value using the prevailing rate of exchange on this date.

2. Balance Sheet Date: Adjust the payable or receivable to its U.S. dollar equivalent end-of-period value, using the current exchange rate. Recognise any exchange gain or loss for the change in rates between transaction and balance sheet date.
3. **Settlement Date.** First adjust the foreign currency payable or receivable for the change in the exchange rate between transaction date, balance sheet date and the settlement date, recording any exchange gain or loss as required, then record the settlement of the foreign currency payable or receivable.

The subsidiary and the GAFI agreed to recognise currency value differences emerging, as a result of the two methods of foreign currency adjustment, in the income statement of the period in which the exchange rates changes.

To illustrate the methods of treating these transactions, a brief explanation revealed during interview would be useful.

Figure 7.1 shows how Squibb records gains or losses that arise from the purchase of raw materials denominated in U.S. dollars. On October 1, 1987, Squibb Egypt acquired goods on open account from the Italian subsidiary for $10,000, or L.E. 18,500, payment to be made in 90 days. The exchange rate was L.E. 1.85/$ on Oct. 1, 1987, L.E. 1.92/$ on Nov. 30, 1987, and L.E. 1.96/$ (prevailing rate) and L.E. 2.20/$ (free market) on the settlement date. As mentioned earlier, Squibb Egypt prepares its financial statements on its year-end, Nov. 30, and any gain or loss is immediately recognised in the income statement in the period incurred.

**Figure 7.1**

Journal entries for the effects of purchase of raw materials denominated in dollars on Squibb's accounts*

1. The initial recording of the transaction: Oct. 1, 1987

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>18,500</td>
</tr>
<tr>
<td>Accounts Payable-Intercompany</td>
<td>18,500</td>
</tr>
<tr>
<td>(Italian subsidiary)</td>
<td></td>
</tr>
<tr>
<td>L.E. 18,500 = $10,000 x L.E. 1.85 prevailing rate</td>
<td></td>
</tr>
</tbody>
</table>
2. Balance Sheet Date: Nov. 30, 1987

Foreign Currency Transaction Loss 0,700
Accounts Payable - intercompany 0,700

Adjust payable denominated in dollar to L.E. equivalent and recognise exchange loss:
L.E. 19,200 = $ 10,000 x L.E. 1.92
-L.E. 18,500 = $ 10,000 x L.E. 1.85
--------
700 = $ 10,000 x L.E. (1.92 -1.85)

3. Settlement Date, Jan. 1, 1988

Foreign currency transaction loss 1,000
Accounts Payable - intercompany 19,200
Foreign Currency Account 20,200
(Cash)

Settle foreign currency payable and recognise exchange loss:
L.E. 5,500 = $2,500 x L.E. 2.20 (Percentage of finance from free market 25%)
L.E. 14,700 = $7,500 x L.E. 1.96
--------
20,200
- 19,200
--------
1,000

(*) Interview with the Financial Manager of Squibb on 22nd Jan., 1988.

- The exchange rates used in this calculation were obtained from The Finance and Economic Affairs Committee" Report of the Foreign Exchange rates Problems In Egypt" El- Shora Council Cairo, 1988.

It seems clear from the above example that the dependence of Squibb Egypt on imported raw materials together with the movement of prevailing exchange rates between the purchase and payment dates and the dependence on the free market rate for financing a part of accounts payable, created large transaction exposure from year to year and resulted in a negative impact on the financial results during the period concerned. For example, the
foreign currency losses charged to income as a result of the import of raw materials denominated in dollars are estimated at L.E. 0,700 in 1987 and L.E. 1,000 in 1988.

Transaction exposure also arises from borrowing of funds, payment of wages and salaries, royalties, interest and equipment purchased in a foreign currency. All these transactions have a negative impact on the financial results of the subsidiary.

7.4.1.1.3 Price Control

The financial manager of Squibb Egypt believes that:

"Within the centrally controlled price structure that exists in Egypt, we are unable to pass additional costs to consumers. Consequently, they always cause our income to show a marked deviation. In other words, the pricing policy puts our subsidiary in a very difficult position in terms of its profitability. Accordingly, we have discussed this problem repeatedly throughout several years with the Organisation of Drugs and General Authority for Foreign Investment, but to no avail. However, we continue to operate in an environment of price control and increasing production costs."

However, it can be argued that the prices of products sold by local enterprises compared with those supplied by Squibb Egypt are relatively cheap. Table 7.3 gives a brief comparison between some retail prices of Squibb Egypt and those of local companies.

It can be seen from this table, for example, that the retail price of Antibiotics (12 Caps, 500mg) produced by Squibb Egypt is L.E. 6.55 per twelve tablets as compared with L.E. 3.10 for a local product.
### Table 7.3
Price Comparison of Subsidiary and Local Drugs - Retail Price in L.E. 1986 (Main Products)

<table>
<thead>
<tr>
<th>Dosage Form</th>
<th>Subsidiary Name</th>
<th>Product Price</th>
<th>Local Name</th>
<th>Equivalent Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>12 Caps 250mg Velosef</td>
<td>3.50</td>
<td>Oxytetrine</td>
<td>2.05</td>
<td></td>
</tr>
<tr>
<td>12 Caps 500mg Velosef</td>
<td>6.55</td>
<td></td>
<td>3.10</td>
<td></td>
</tr>
<tr>
<td>12 Caps 250mg Dexacillin</td>
<td>2.00</td>
<td>Sigmacid</td>
<td>1.15</td>
<td></td>
</tr>
<tr>
<td>12 Caps 500mg Dexacillin</td>
<td>4.00</td>
<td></td>
<td>2.10</td>
<td></td>
</tr>
<tr>
<td>2. Corticosteroids</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Tabs Kenacort Tabs 5mg</td>
<td>1.00</td>
<td>Locacurintine</td>
<td>0.85</td>
<td></td>
</tr>
<tr>
<td>5mg Kenacort-A Cream</td>
<td>0.75</td>
<td>Locacurintine</td>
<td>0.60</td>
<td></td>
</tr>
<tr>
<td>3. Psychotropics</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 Tabs Motival Tabs</td>
<td>1.50</td>
<td>Tranquadain</td>
<td>1.40</td>
<td></td>
</tr>
<tr>
<td>4. Cardiovascular Drugs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20 Tabs Capoten Tabs 25mg</td>
<td>1.50</td>
<td>Curtizon</td>
<td>4.00</td>
<td></td>
</tr>
<tr>
<td>5. Vitamins</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30 Tabs Theragran Tabs</td>
<td>4.00</td>
<td>Vi. Ci. Ferrol</td>
<td>3.10</td>
<td></td>
</tr>
</tbody>
</table>


During an interview with the marketing manager of Squibb Egypt on 16th Dec., 1987, it was indicated that there are a number of reasons for the price differential between Squibb Egypt’s products and their local equivalents. The first is Squibb’s high technology, recovery of R & D costs, and raw material availability compared with local enterprises. The second is the monopoly governing Squibb’s drug production and sales. Thirdly, direct costs relative to production are markedly higher for Squibb than for local enterprises (see chapter 9). Fourth, products with an internationally renowned brand name are more attractive to customers than lesser-known and perhaps generic product equivalents from local enterprises. Fifth, is the quality of Squibb’s drugs’ ingredients and their medical importance in
the local market as a foreign brand. Finally, the national enterprises are often forced to price their drugs around 10-30% below their foreign equivalents in order to meet social objectives (GOD, Dept. of Statistics, 1988). This was confirmed by the Head of the Planning and Follow-Up Department (PFUD) at GOD, who stated that all local companies should price essential drugs groups at very near to cost in order to fulfil the objectives of socio-economic plans, while inessential drug groups could include an allowance for a relatively higher profit margin.

As far as government control of the pharmaceutical market is concerned, domestic drug prices are set by the GOD on the basis of an accountancy approach, taking into account several factors including competition, technology, consumer price perceptions, product differentiation, inflation, etc. The accounting formula is:

**Full cost (fixed and variable) + % for profit margin**

On the basis of this formula, the GOD decided to apply two rules for fixing the price of Squibb Egypt's products. The first is the international price standard, which stipulates that the price of a local drug must not exceed that of its equivalent on the international level. The second standard is the therapeutic value of drugs. The price of those which are deemed essential must be very near to cost, whereas the prices of inessential drugs, such as vitamins may include an allowance for relatively higher profit margins.
The above steps for price and profit measuring are applied for both local and foreign enterprises operating. However, in 1984 a problem occurred when applying this pricing policy to individual drugs produced by Squibb. The problem was that the prices determined by GOD of all essential drugs were below those estimated by the Squibb Corporation, while the prices of inessential drugs were in conformity with the estimated prices.

In this context, on June, 1985, the general manager of Squibb Egypt, on behalf of his company criticised the pricing policy used by GOD in a detailed memorandum, claiming that it caused several difficulties for the subsidiary's profit and its competitive position in the Egyptian market (interview with Marketing Manager on 26th Jan., 1988). The general manager insisted on passing cost increases on to the consumers in the form of price increases. As a result of the complaint, the possibility of increasing drug prices was studied by a committee of specialists from different ministries and agencies during 1986. The committee decided that Squibb Egypt could raise the prices of essential drugs in relation to their imported equivalent, and add an annual percentage ranging between 10% and 15% on its direct cost to calculate a reasonable profit margin for these drugs in relation to their medical importance on the market. This means that the general price level of all the subsidiary's drugs will tend to rise over time, in line with rises in the general international price level for drugs.
In this centrally-controlled price structure, it is evident that the results of Squibb Egypt’s operation have been seriously affected and it has shown large and sustained losses throughout the 1980s (see chapter 9).

7.4.1.1.4 Transfer Pricing

Transfer price manipulations include overpricing raw materials of drugs, fees charged for foreign and regional managers and head office services and royalties on technology transferred. This section identifies and examines the scope for Squibb Egypt to employ such practices to understate reported profit and the process operated by GAFI and GOD to check this.

7.4.1.1.4.1 Raw Materials Overpricing

One of the most effective methods for Squibb to conceal large profits is the abuse of transfer pricing for intermediate goods. This phenomenon was observed during an interview with both Squibb’s financial manager and the Head of the Follow-up and Performance Evaluation Division (FUPED) at the GAFI and the Head of the planning and Follow-Up Department (PFUD) at GOD. The former claimed (interview on 16th Dec., 1987):

"We do not know anything about the abuse of the transfer pricing mechanism within the Squibb Corporation family. However, if someone wanted to find out about it, he could check our subsidiary’s intercompany transactions through the financial reports of corporation itself. In fact, as I know, our operating results often show a loss as a result of high production costs."
Officials at the GAFI were asked whether Squibb Egypt uses transfer pricing to understate its reported profit. In reply, it was stated that Squibb Egypt’s agreement includes a restrictive clause stipulating that active raw materials and intermediate products can only be purchased from the Squibb group. The Code of Foreign Investment agreed to this, on condition that Squibb provided enough information about import transactions to the FUPED at the GAFI. In theory, if the GAFI is in doubt about the value of the subsidiary’s import transactions, then competitive international prices are taken as the standard in revaluing the import transactions and recalculating the subsidiary’s reported profits. However, it was not clear whether this actually happens, for it was stated that with a market as wide and complex as that for pharmaceuticals, this might be difficult, especially as the number of patented names and kinds of pharmaceutical chemicals and raw materials exceeds 22000. This gives very limited control over the price at which raw materials are obtained as compared with competitive international prices (interview on 31st Dec., 1987).

At the GOD, the same question regarding the use of transfer pricing was asked. In reply, it was stated that because of the shortage of manufactured local drugs and because Squibb Egypt has easy access to imported raw materials and intermediate products from its parent company without any obstacles, it has imported chemicals necessary for production at greatly inflated prices. For example, in
1985, the active ingredient for Decacilen - Squibb's brand patented name for Empicillin - was made available from an Italian exporter at $360 per Kilogram as compared with the parent company's price of $780 per Kilogram. Squibb Egypt's management was asked by the GOD to reduce its price but Squibb's head office argued that the Italian supplies were of doubtful quality and therefore not comparable for negotiation purposes. This information came from a confidential report published by the PFUD at GOD, in late 1985. The absolute difference between the total value at the price paid by Squibb Egypt and the total value at competitive prices for imported raw materials is shown in table 7.4. This compares Squibb Egypt as a wholly foreign owned enterprise and Alexandria Company as a wholly domestically-owned enterprise, and shows the components of production costs of the two companies in terms of the percentage of each component to sales.

The most striking feature is the difference in the percentage of raw materials to sales. While the percentage of imported raw materials of Squibb Egypt represented approximately 93.4% of sales, those of Alexandria Company accounted for 45.8%.

This difference is attributable to two factors:
(a) The subsidiary relies completely upon the purchase of raw materials from the Squibb Corporation family (the Italian and Greek subsidiaries) at greatly inflated prices, while the Alexandria Company follows government
Table 7.4
Comparison between the prices paid by Squibb Egypt and the Alexandria Company for raw materials in 1985

<table>
<thead>
<tr>
<th></th>
<th>Squibb</th>
<th>Alexandria*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>LEm.</td>
<td>%</td>
</tr>
<tr>
<td>Sales</td>
<td>29.389</td>
<td>100%</td>
</tr>
<tr>
<td>Direct Cost of Sales:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw Materials</td>
<td>27.454</td>
<td>93.4%</td>
</tr>
<tr>
<td>Labour</td>
<td>1.507</td>
<td>5.1%</td>
</tr>
<tr>
<td>Other costs</td>
<td>18.484</td>
<td>62.9%</td>
</tr>
</tbody>
</table>

* We selected Alexandria Company because it has a similar capital structure and sales level in the Egyptian market. Squibb depends on raw materials imported from within the group and the Alexandria Company relies upon licensing agreements with Bayer, Hommel and Mowath and Moore.


instructions in importing its requirements of active raw materials. The GOD is responsible for keeping a watchful eye on the level and movement of prices of all imported raw materials required for local wholly-owned companies. In this context, GOD introduced a clause in its regulations in 1975 specifying that raw materials and intermediate products obtained from international suppliers by domestic companies must be imported with permission from the GOD, at the lowest possible prices. This price competition was to be encouraged within a restricted sellers' market of 90 large reputable international firms, to ensure quality and reduced prices. Accordingly, the Alexandria Company asked its licenser to
review the price of its imported raw materials and refused to buy certain ingredients until Bayer had reduced its prices three times (Interview with the Head of the Imports & Export department at GOD on 20th Jan, 1988).

(b) Because of its relationship with its parent company, Squibb Egypt is more capable than Alexandria Company of charging a greater proportion of transfer prices as cost. Thus comparing the imported raw materials percentages of the two companies, it can be shown from table 7.4 that the raw materials overpricing is about 106%. The percentage of overpricing is calculated on the basis of Vaitsos' measure of overpricing as used in his Colombian pharmaceutical sector case study; Vaitsos, (1970) defined overpricing as:

\[
\text{Overpricing of Raw Materials} = \frac{27.454 - 13.335}{13.335} \times 100 = 106\%
\]

This reflects the extent of Squibb Egypt's use of transfer pricing to maximise repatriation of funds to the parent company. Various factors have influenced the overpricing policy: the risk factor, the monopoly position which allows the company to charge whatever price it chooses, the overall rate of return on investment, foreign exchange rates, tax regulation, and host government policies regarding transferable funds.

It is clear that in the absence of efficient control by
the Egyptian government over Squibb Egypt's intercompany transactions, it has been possible to use transfer pricing to understate the company's reported profit. Unless transfer price manipulations are checked, the accounting reports of the company will continue to be distorted. If the government is to monitor this factor appropriately, it must have knowledge of the level of prices in the countries of origin or on the international market. Therefore, the main task of government in checking overpricing of intermediate products is to separate the raw materials and intermediate products and to group them into classes according to their generic names with information on their source, the name of the manufacturer, the brand name, and the price of each unit. Up to this point the government has the ability to examine and compare the price and other information stated on an invoice with the standard.

However, in practice, it is very difficult for Egyptian officials to control transfer price manipulation, especially in the case of Squibb, as a result of its monopoly patent rights.

7.4.1.2 Royalties

For the pharmaceutical industry, royalties generally range from 3% to 10% of sales, but lower and higher royalties occur; for example, those on modern drugs are around 20% (Shadded, S.M., 1979).

In Egypt, since 1958, royalties have been set at exactly 5% (Ibid). Yet, according to the agreement,
royalties paid to Squibb Egypt are 7.5% on old drugs and 15% on modern drugs, for three years only, on condition that the amount of royalties does not exceed L.E. 1 million. It is important to note that royalties are calculated on net sales and are not liable to any deductions for income tax. The financial manager stated that, although royalties of 7.5% give a very small return to Squibb in comparison with those enjoyed by its fellow subsidiaries in other countries, an additional 10% of sales is allowed as advertising expenses to compensate for the low level of royalty payments (interview on 19th Dec., 1987).

Royalty payments to Squibb thus seem to be under the control of the Egyptian government. Determination of royalties is conducted as follows:

1. An application for transfer should be submitted to the GAFI and GOD setting forth the royalties to be transferred. The application should be accompanied by a copy of the subsidiary's balance sheet, the income statement for the period in which the royalties were earned, and a certificate from "Hazim Hassan Company", Chartered accountants, certifying that the royalties have been calculated in accordance with government regulations.

2. The GAFI and GOD study the documents to ascertain that:
   a) the company has discharged all its financial obligations to the state.
   b) the amount of royalties has been properly calculated in accordance with the establishment agreement and government
3. Based on the result of this investigation, the royalties may be recalculated. In this case a letter stating the result of the investigation is sent to Squibb Egypt, which has the right to negotiate until the two parties finally reach an agreement.

4. Once the royalties have been agreed, they may be transferred at the highest prevailing rate of foreign exchange, subject to its earning sufficient foreign exchange. Squibb's bank must check the certificate issued by the GAFI to verify the amount before transfer to the parent company.

7.4.1.3 Commission Fee for Services and Overhead Allocations

Squibb Egypt's agreement includes the payment of fees for the parent company's technical services (installation and maintenance of machinery) to the subsidiary in Egypt. However, the more substantial payment included in the agreement is the allocation of fixed overheads (which includes the advertising expenses of the publicity office of the parent company).

The overhead allocation accounts for 10 percent of net sales as a contribution to the advertising office in Egypt, to be paid in Egyptian currency, according to the agreement recommended in 1974 by the GOD. This payment was allowed as compensation for the low level of royalty payments as mentioned above.

However, the percentage of overhead allocation is not
monitored by either GAFI or GOD, partly because it does not appear in the financial statements of the subsidiary and partly due to lack of experience on the part of GAFI and GOD staff in dealing with this type of expense. This payment must be monitored for two reasons: to eliminate transfer pricing techniques and to evaluate performance. Unless overhead allocations are checked, the reported profit of Squibb Egypt will continue to be distorted.

7.5 Taxation Policy

The income tax revenue which stems from Squibb Egypt is considered essential to Egyptian development policy. However, no revenue has accrued to the state since the end of Squibb’s tax exemption period in 1984. This is because the company has shown continued losses since its first date of operation in 1979.

During an interview with a tax officer at the Foreign Investment Tax Office (FITO) at the Tax Administration (TA) on 22nd Dec., 1987, it was stated that:

"Squibb Egypt, like other foreign enterprises, operates within Egyptian law. Squibb Egypt seeks to minimise its Egyptian tax burden and weaken the position of the Egyptian pound by using several techniques, including artificial transfer pricing of intercompany transactions, adjustments of technical fees and the like. Therefore, for tax purposes, steps must be taken to scrutinise Squibb Egypt’s financial statements."

As with other pharmaceutical enterprises, the tax rate applied for Squibb Egypt’s profit is 40 percent, except that profits earned through exports are taxed at 32 percent (Law No. 157 of 1981). The tax rate is applied after the
completion of the exemption period allowed by Foreign
Investment Law 34 of 1974 (Article 16).

The process of tax calculation starts with gathering
the data required from the financial reports submitted by
the subsidiary to the FITO.

The tax liability is based on net profit after the
deduction of certain costs:
1. The rental value of premises occupied by the enterprise.
2. The real depreciation of fixed assets within the tax
period.
3. Twenty-five percent of the cost of new machines and
equipment bought by the company to be used in production in
addition to depreciation stipulated under the above
paragraph.
4. Taxes paid by the company except those due on the
profits under examination.
5. Subscriptions paid to the government.
6. Appropriations made to meet certain losses or financial
burdens that are sure to take place and are not determined.
These should not exceed 5 percent of net annual profits.
7. The amount of wages, salaries and social insurance paid
by the company to its workers.

The researcher discussed with the tax inspector the
investigation of the subsidiary's financial reports, with a
view to finding out any problems relating to this process,
and any changes required.

The first question concerned the fact that the FITO
relies on the subsidiary's external auditor's report, which
expresses an opinion as to the fairness of the financial statements. It was asked why FITO relies on the report of an external auditor, who is not a government agent or appointee. In reply, it was stated that although the external auditor's report is the basis for the examination of the company's financial statements, FITO depends mainly on the EUAS and rules adopted in tax law No. 157 of 1981 and its amendment in 1983 in this respect. This is because of the limited interest of the external auditor in protecting national objectives and his lack of interest in revealing any manipulation exercised by the subsidiary.

In response to a question as to problems which have arisen during the tax examination of Squibb financial statements, it was stated that many problems have occurred, including, foreign exchange gains or losses, depreciation, capital assets gains and losses and prior years' losses.

7.5.1 Foreign Exchange Effects

Foreign exchange is one problem faced by the tax inspector, due partly to fluctuations in the foreign exchange rate and partly to differences in accounting policies used.

Because of the depreciation of the Egyptian pound against the US. dollar over the life of the subsidiary, and the company's persistent indebtedness to its parent in dollars, translation losses have been greater than gains. As a consequence, the financial statements have shown foreign exchange differences in the years 1984 - 1987 amounting to

As discussed earlier, Squibb treats translation gains or losses as unrealised and they are reported as a separate component of shareholder's equity, while transaction losses are included in net income, except for those relating to intercompany transactions of a long term investment nature which are accumulated in shareholder's equity. In this respect, the approach of Tax Law in dealing with this problem is not consistent with the subsidiary's approach. FITO emphasised that exchange differences arising from translation of current assets and current liabilities at a balance sheet date must be recognised for tax purposes.

As for transaction gains and losses, it was accepted by both sides that gains or losses in respect of any transaction should be taken into account for tax purposes.

In fact, there is a disparity between the methods of treating translation gains or losses resulting from foreign exchange differences, used by the Tax Law and the subsidiary. Therefore, the translation methods must be reconciled. In order to perform the reconciliation, the subsidiary and TA should follow the EUAS in this respect.

7.5.2 Depreciation

Tax Law permits the depreciation of the subsidiary's fixed assets to be charged as a cost to the income statement for the period in which the profits were earned. The method in use is the straight-line method for both
sides. However, the percentages to be applied vary according to the accounting system used (see section 7.4.1). As a consequence, the Tax Inspector stipulated that a list of depreciation percentages of assets and another new one including the date of purchase, value, and additional depreciation must be submitted. In fact, the depreciation percentages in use by the tax administration are the same as those adopted in the EUAS (see section 7.4.1).

Based on the EUAS percentages, FITO recalculates the depreciation charged to profits and any depreciation differences should be recognised in the income statement for tax purposes.

Many other items related to the subsidiary are treated in the same way as the depreciation and foreign exchange differences. These include interest on loans, wages and salaries, prior year expenses, etc.

7.5.3 Transfer pricing

Another question asked was what would happen in the case of the discovery that Squibb Egypt employed transfer pricing techniques to understate its reported profit? In answer, it was stated that if FITO is in doubt about the cost of sales, then documentary audit is taken as the main technique to discover any manipulation exercised by the subsidiary. Nevertheless, FITO often accepts the price stated on an invoice, whether intercompany or third party.

It can been seen that the process of examining the financial statements of Squibb Egypt by FITO is basically aimed at determining income tax liability. However, the
actual application has shortcomings which reduce its efficiency:

1. The process depends mostly on information submitted by Squibb itself, certified by its auditor. This results in failure to disclose adequate information for tax investigation, due to the lack of independence of the external auditor.

2. the poor implementation of tax investigation procedures;

3. The poor definition and different interpretations of tax legislation and regulations;

4. Conflicts in the articles of the code of foreign investment and tax law regarding tax incentives and their applications;

5. FITO's staff lack experience in dealing with such issues as transfer pricing, management fees, etc.

7.6 Conclusions

The purpose of this chapter was to examine the process of financial control currently operated by the government over Squibb Egypt. The process has two main elements:

(1) determining the amount of transferable profits.
(2) determining the subsidiary's income tax liability.

However, the process as currently operated has shortcomings which significantly reduce its efficiency. In this respect, the Head of the FUAD explained in interview that:

"The formal financial control process is obvious and fully registered in the code of foreign
investment, and its regulation and investment decrees and tax legislation. However, in practice, the fact remains that control systems do not always work well because of lack of experience in this respect as a result of the neglect of international business studies in accounting departments of universities. Moreover, the government usually approved proposals because it wanted to maximise investment and did not want to interfere excessively. Consequently, I disagree with this approach because foreign enterprises should be under our eyes in order to solve our problems."

In fact, the deficiencies of the financial control process lie in the following areas:

1. The process depends mostly on information submitted by Squibb itself, certified by its auditor. This results in failure to disclose adequate information for follow-up purposes, due to the lack of independence of the external auditor.

2. In determining the transferable profits and the income tax charge, the process ignores the possibility that transfer pricing techniques have been used to understate the subsidiary’s reported profit. This is basically attributable to government officials’ lack of experience in dealing with such issues as foreign exchange, pricing policy, transfer pricing, technical fees, etc.

The above findings strongly suggest that the government should re-evaluate and tighten up the existing financial control process of determining transferable profits and income tax of foreign enterprises.
Chapter VIII

Administrative Control Techniques

8.1 Introduction

The preceding chapter examined the financial control process over Squibb Egypt as currently operated by the Egyptian government.

To complete the operational control process, administrative control is also required to ensure that Squibb Egypt's activities are carried out according to the agreed plan. This chapter, therefore, deals with the process currently operated by the Organisation of Drugs, the General Companies Administration and the Ministry of Manpower to follow up special areas of the activities of Squibb Egypt. These include planning machinery, production, quality control and employment.

8.2 Planning Machinery and Egyptian Government Control

This section examines the process of planning as currently operated by Squibb Egypt, how it operates, how effective it is, and the means by which the head office and the Egyptian government can control it. The process takes two forms: budget approval and budgets as control devices.

8.2.1 Budget approval

Squibb Egypt prepares a comprehensive local plan within the Corporation's planning framework and taking into account Egyptian requirements. The most important bodies controlling its planning system are the Organisation of Drugs and the General Authority for Foreign Investment. The major
components of the planning system are:

1- a five-year plan which is often referred to as a long-term strategic plan;
2- a medium-term plan;
3- a one-year plan that is referred to as a short-term plan (master budget), and which is broken into quarterly operating plans; and
4- a projection plan which is prepared in accordance with actual progress. This plan is drawn up each three months.

In relation to these plans, the financial manager pointed out (interview on 19th Jan., 1988) that:

"The company's total planning system gives a great deal of attention to integration of the overall plans which take most of the Egyptian economic objectives and obligations into account"

In constructing the subsidiary's annual budget cycle, three important steps should be followed:

1- identifying the subsidiary's and the Egyptian government's targets;
2- attempting to reconcile these two objectives with the main targets of the parent company;
3- attempting to compile comprehensive data to secure the fulfilment of these targets for the year ahead.

The master budget provides a very detailed plan for the coming year. It is prepared on an annual and quarterly basis, including sales, production, etc., quantifying expectations regarding future income, cash flows, financial
position, and supporting plans. Figure 8.1 indicates the various elements of the master budget which is classified into two main parts: operating budget and financial budget. Each involves a separate procedure. The first focuses on the income statement and its supporting schedules. The second focuses upon the effect that the operating budget and other plans (such as capital expenditure and repayment of debts) will have on cash.

The responsibility for the preparation of the master budget rests with the general manager. However, he often delegates to the financial manager responsibility for dealing with the details of the overall budget and its sub-plans. The main tasks of the finance division in this context are to:

1- assemble the plans of all divisions, including their proposed capital and operating expenses requirements;
2- prepare quarterly projected financial statements comprising capital expenditure, and estimated revenue and costs, and then combine them into a one year budget for the corporation's consolidated budget;
3- set up two cash flow budgets, one for intercompany accounts, and the other for general transactions;
4- discuss the above reports and other problems with the top management to ensure that realistic goals are set for the subsidiary, and that funds are available to finance them.

The sales budget is the starting point for the planning process, for it affects most of the other budgets. It proceeds from the forecast of demand for the subsidiary's
products at the expected prices. Since the purpose of Squibb Egypt is to satisfy the high demand for pharmaceuticals in the Egyptian market, most of the subsidiary's production is assumed to be absorbed by the market, and there are few forecasting problems. Figure 8.2 shows the formulation of the sale budget in the corporation's system.

However, there are two vital factors which have a
considerable effect on the sales budget; government pricing policy, and demand. The subsidiary is asked to provide the Organisation of Drugs with information about its sales and production for coming years. This:

Figure 8.2

Squibb Corporation

Sales Budget

<table>
<thead>
<tr>
<th>Therapeutic Group</th>
<th>Code No.</th>
<th>Unit Dosage</th>
<th>Quarter 1 (Quan. Val.)</th>
<th>Quarter 2 (Quan. Val.)</th>
<th>Quarter 3 (Quan. Val.)</th>
<th>Quarter 4 (Quan. Val.)</th>
<th>Total (Quan. Val.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antibiotics</td>
<td></td>
<td></td>
<td>Quan. Val. 1</td>
<td>Quan. Val. 2</td>
<td>Quan. Val. 3</td>
<td>Quan. Val. 4</td>
<td>Quan. Val. Total</td>
</tr>
<tr>
<td>Corticosteroids</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Psychotropics</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cardiovascular</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vitamins</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. helps the Organisation of Drugs to compile an overall plan for the year ahead for the Ministry of Health, and beyond that, the national plan, including volume of products, sales, exports, etc.

2. assists the Organisation of Drugs to determine the price of drugs. In fact, the Organisation stipulates that each company should submit a report including production cost details to fix a price for drugs components. This is partly to keep pharmaceuticals at reasonable prices and partly to reduce domination by multinationals in the Egyptian market.

3. gives the Organisation of Drugs a basis for following up
the operations of the subsidiary, which it asks to report on achievement of the plans from time to time.

Furthermore, the Organisation of Drugs imposes restrictions upon certain types of product, such as vitamins, in order to maintain the balance of the market. The volume produced of each type of drug is subject to the specifications and limitations set by the Ministry of Health (see section 8.4).

In accordance with the sales budget, the production manager and his colleagues prepare the production budget based on the recommendations of the Organisation of Drugs and the corporation’s policy.

Squibb Egypt’s production budget is thus subject to three factors: government policy, corporation policies and production capacity. The pharmaceuticals produced at Squibb are estimated to include 52 types of drug, and more than one hundred types of raw material are required for the production processes. The major task of the production planning and purchasing division is to ensure that raw materials, whether foreign or local, are available whenever required. However, as the financial manager explained:

"We have no problem with holding large raw material stocks because the subsidiary has an open account with the corporation to get the main raw materials required at any time and without financial problems. The extra warehouse space exists, and local raw materials are available but the prices are always going up and the quality is low. However, the cost of imported raw materials is increasing considerably due to high Egyptian tariffs, which results ultimately in losses. In addition there is the problem of local
raw materials which are inefficient. As an alternative we can import high quality goods at 25% above the original imported cost to allow for customs. This leads to an increase in production cost and causes losses as well.

After sales are budgeted, five separate budgets are prepared to determine the cost of drugs sold. These are the inventory, purchase, labour, overhead and operating expenses budgets. These budgets provide enough information for a budgeted income statement. Their approval by the Egyptian government is subject to the General Companies Administration, the General Authority for Foreign Investment and the Organisation of Drugs. The views of these bodies are placed before the Organisation of Drugs’ Board of Directors. The subsidiary’s operating budget is approved in the event that the Board of Directors gives its approval by a majority vote. The subsidiary is informed of this approval by a letter accompanying the budget.

The second major part of the master budget is the financial budget, which consists of the capital expenditure budget, cash budget, year-end balance sheet, and statement of changes in the subsidiary’s financial position.

The capital expenditure budget is basically concerned with the estimated cost of new capital assets required, including the cost of replacing existing assets.

The cash budget is mainly concerned with the translation of all of the subsidiary budgets into cash receipts and expenditures. The responsibility for the financial translation of these budgets rests with the
finance division. Once they are agreed, the budgeted income statement, balance sheet and cash position of the subsidiary are completed both quarterly and annually.

The approval of the capital expenditure budget and cash budget rests with the General Authority for Foreign Investment. These budgets, together with the follow up and audit report, are sent to the Vice Chairman of the Investment Authority. The decision of this body is brought before the Board of Directors of the Authority. The subsidiary is informed of its decision by letter accompanying the capital budget.

Based on the outcomes of the above the processes, the master budget is then sent to the regional manager of Squibb for his opinion and on its acceptability. He assesses its strengths and weaknesses in terms of profitability goals and the availability of funds to finance it. If the budget is approved at the regional level, then it will be sent directly to headquarters for review and final approval. The Board of Directors of Squibb Corporation scrutinises the overall budgets, often assisted by a budgeting committee consisting of members of top management from each of the company’s regions. The task of the committee is to set general guidelines for worldwide subsidiaries to be followed by the regional managers and subsidiaries in setting and following up their own budgets.

8.2.2 Budgets as Control Devices

Once final approval has been obtained, the master budget needs to be implemented and controlled to monitor
actual progress and take action if it is necessary. Three steps need to be taken for the implementation of this budget: recording of actual performance, comparison of actual performance with the budget and actual performance for the previous period, and revision of any items not proceeding according to the budget. Any difference between the actual performance and the current budget is ascribed to variances, which are broken down into four factors: volume, prices, foreign exchange rate, and other factors.

It can be seen that budgets represent an integral part of both internal control and control by the Egyptian government. This puts the Egyptian government in a better position to follow up budget implementation and to take appropriate action in the future by means of a comparison between the planned and actual results.

By virtue of the foreign investment laws and regulations, the Organisation of Drugs and the General Authority for Foreign Investment are in charge of following up the subsidiary’s operations to ensure that the budget is correctly implemented according to the Health Ministry’s plan and the national economic plan. The subsidiary in turn is responsible for providing the Department of Planning and Follow-Up at the Organisation of Drugs with a copy of its quarterly production and sales reports. In addition, to complete the control cycle, the Foreign Investment Authority demands an annual operating and capital budget in order to make sure that the subsidiary’s financial position is
consistent with the requirements of the foreign investment laws.

Thus, the Egyptian control system is set out in the code of foreign investment and systematically operated to achieve national interests. However, the actual application of the process cannot help in achieving these interests. This is due partly to the shortage of qualified staff responsible for carrying out this control process and partly to some shortcomings which significantly reduce its efficiency. For example:

1. The government bodies rely in the planning process on the budget data prepared by the subsidiary’s planners who ignore completely the objectives of the country.

2. The government control process ignores the possibility that transfer pricing practices may be used to understate reported profits.

3. The government control process ignores the possibility that the subsidiary is trying to avoid the financial risks of devaluation of the Egyptian pound.

8.3 Production Control

The process of following up production is aimed at determining the volume of pharmaceuticals that may be produced and monitoring the subsidiary’s performance in this respect. In this context, the Egyptian Investment Code gives the right to the Organisation of Drugs to monitor the production process. This is done in the light of the industry’s plan to ensure that the production level is attained in order to meet local demand and reduce foreign
To this end, first, the DPFU, i.e., the Department of Planning and Follow-up at the Organisation of Drugs, determines in conjunction with the marketing manager of the subsidiary the volume of drugs that may be produced for local market and exports. This is done by means of a plan designed by the Organisation of Drugs.

Therefore, the production control process is normally conducted as follows:

1. A form called "the plan report" is sent to Squibb Egypt at the time of preparing the annual plan for the pharmaceutical industry in order to estimate the subsidiary's annual production budget classified into therapeutic groups and distributed quarterly and monthly. The plan report includes the following data:
   a. Therapeutic Groups classified into antibiotics, corticosteroids, psychotropics and cardiovascular;
   b. Item's code number, unit, and dosage form;
   c. Output: volume and value classified into local sales, exports, and inventory (opening and closing balance).

2. In turn, the plan report must be submitted within a month to the DPFU setting out the level of production to be produced. It should be accompanied by a copy of the subsidiary's sales and production budgets for the period in which the production is to be produced and sold. The subsidiary's production budget is prepared quarterly and monthly and classified into local sales, exports and
inventory in terms of public and ex-factory prices.

3. The DPFU studies these documents to ascertain that the subsidiary’s production capacity is compatible with the pharmaceutical industry’s plan and the national economic plan.

4. As a result of this investigation, the production figures may need to be revised. In this case a letter is sent to the subsidiary, whose marketing manager has the right to negotiate the Organisation of Drugs’ proposed revisions. This takes about two weeks until the two parties finally agree the subsidiary’s annual sales and production budgets.

5. Once the annual sales and production budgets have been agreed, they are sent directly to the head office for final approval.

The process of evaluating the subsidiary’s production performance starts with gathering actual data from the production follow-up report which is also designed by the DPFU.

The marketing manager of the subsidiary is usually responsible for providing the DPFU with the monthly production report, which includes the volume and value of actual output classified into local sales, exports, and inventory (opening and closing balances). The details of the Production Follow-up Report for October, 1987 are given in table 8.1 below.
<table>
<thead>
<tr>
<th>Therapeutic Group</th>
<th>Item's Code No.</th>
<th>Unit</th>
<th>Dosage Form</th>
<th>Production Quan.</th>
<th>Local Sales Quan.</th>
<th>Export Quan.</th>
<th>Opening Stock Val. (L. E. 1,000's)</th>
<th>Closing Stock Val. (L. E. 1,000's)</th>
<th>Value in L. E. thousand</th>
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<td><strong>1. Antibiotics</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>A: Broad Spectrum</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Velosef</td>
<td>11312</td>
<td>250 mg</td>
<td>Capsule</td>
<td>15</td>
<td>45</td>
<td>16</td>
<td>56</td>
<td>1.5</td>
<td>4.5</td>
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<tr>
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<td>500 mg</td>
<td>Capsule</td>
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<td>72</td>
<td>11</td>
<td>77</td>
<td>2</td>
<td>13.7</td>
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<td>Suspension</td>
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<td>27.5</td>
<td>8.5</td>
<td>25.5</td>
<td>1</td>
<td>2.8</td>
</tr>
<tr>
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<td>36</td>
<td>9</td>
<td>42.8</td>
<td>1</td>
<td>4.5</td>
</tr>
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<td>Vial</td>
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<td>37</td>
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<td>16</td>
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<td>1.5</td>
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<td>Vial</td>
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<td>17</td>
<td>46.8</td>
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<td>6.3</td>
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<td>9.5</td>
<td>36.1</td>
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<td><strong>2. Corticosteroids</strong></td>
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<td>Kenacort</td>
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<td>4 mg</td>
<td>Tablets</td>
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<td>9</td>
<td>12</td>
<td>12</td>
<td>1.0</td>
<td>0.9</td>
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<td>40mg/ml</td>
<td>Inj.</td>
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<td></td>
<td></td>
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<td>50610</td>
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<td>Cream</td>
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<td>35</td>
<td>24.5</td>
<td>6.0</td>
<td>3.6</td>
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<tr>
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<td>Tube/10mg</td>
<td>Cream</td>
<td>45</td>
<td>58.5</td>
<td>37</td>
<td>55.5</td>
<td>3.0</td>
<td>3.9</td>
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<td>50615</td>
<td>Tube/15mg</td>
<td>Cream</td>
<td>40</td>
<td>56.0</td>
<td>32</td>
<td>51.2</td>
<td>6.0</td>
<td>8.4</td>
</tr>
<tr>
<td>Kenacort-B</td>
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<td>Tube/5mg</td>
<td>Ointment</td>
<td>42</td>
<td>23.2</td>
<td>33</td>
<td>24.8</td>
<td>7.0</td>
<td>4.2</td>
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<td>Ointment</td>
<td>40</td>
<td>56.0</td>
<td>36</td>
<td>54.0</td>
<td>5.0</td>
<td>7.0</td>
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<td>57.6</td>
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<td>6.0</td>
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<td>Kenacomb</td>
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<td>Tube/5mg</td>
<td>Cream</td>
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<td>32</td>
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<td>1.0</td>
<td>0.9</td>
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<td>Kenacomb</td>
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<td>Tube/10mg</td>
<td>Cream</td>
<td>45</td>
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<td>Cream</td>
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<td>Tube/5mg</td>
<td>Ointment</td>
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<td>37</td>
<td>37.0</td>
<td>2.5</td>
<td>2.3</td>
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<td>Ointment</td>
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<td>76.5</td>
<td>39</td>
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<td>Cream</td>
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<td>34</td>
<td>29.7</td>
<td>3.0</td>
<td>2.4</td>
</tr>
<tr>
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<td>Tube/10mg</td>
<td>Cream</td>
<td>42</td>
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<td>3.0</td>
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<tr>
<td>Velog</td>
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<td>Cream</td>
<td>44</td>
<td>88.0</td>
<td>36</td>
<td>77.4</td>
<td>2.0</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>3. Psychotropic Drugs</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Moditen</td>
<td>6329</td>
<td>HCl 1mg</td>
<td>Tablets</td>
<td>30</td>
<td>27.0</td>
<td>27</td>
<td>25.6</td>
<td>2.0</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Table 8.1
Monthly Drug Production Report
(October, 31, 1987)
Motival 94521  HCl 0.5mg Tabs  35  49.0  25  37.5  3.0  4.2  2.0  2.0  8  11.2

Modocate 56909  ml  Inj.  60  186.0  50  175.0  10.0  31.0  6  18.6  6  18.6

Siquil 92122  10 mg Tabs  55  19.25  40  16.0  10.0  4.0  12  4.2  17  5.95

92222  25 mg Tabs  22  13.2  18  12.6  12.6  6  1.8  7  4.2

92020  20 mg Inj.  16  4.0  12  3.6  3.0  0.8  4  1.0  5  1.25

4. Cardiovascular Drugs:

Capoten 45220  25 mg Tabs  36  180.0  30  150.0  4.0  20.0  6  30.0  8  40.0

Corgard 24120  60 mg Tabs  35  105.0  40  129.0  3.0  9.0  10  30.0  2  6.0

Pronestyl 75420  250mg Tabs  10  7.5  13  11.05  2.0  1.5  5  3.75  7  3.0

Pronestyl 57920  100mg Inj.  36  21.6  30  21.0  4.0  2.4  4  2.4  6  3.6

5. Vitamins and Hematinics:

Theragran 82618  Bottle/90mg Syrup  26  62.4  22  55.0  5.0  12.0  4  9.6  3  7.2

53331  Hemat. Tabs  16  66.0  15  75.0  2.0  8.0  3  12.0  2  8.0

Rubraton 80030  Bottle/120mg syrup  14  26.6  14  28.0  2.0  3.9  5  9.5  4  7.6


Based on the data extracted from the above report, the subsidiary’s production is evaluated by means of a comparison between the planned and the actual results for the purpose of:

1. Ascertainment that the subsidiary is producing the same products as stated in its budgets and approved by the Organisation of Drugs’ Board of Directors. The calculation of the quantity to be produced is: Opening Stock + Units Produced − Sales = Closing Stock. This comparison is used to measure the subsidiary’s efficiency in achieving its production plan in order to determine whether local needs are being met.

2. Ensuring that the types of drugs required flow smoothly to the local market.

3. Ensuring that the minimum stock level of drugs is always maintained. The minimum level required by the Organisation of Drugs is 10 percent of total sales.
The General Organisation of Drugs thus has the right to apply effective controls over Squibb Egypt's production and export activities. Its first duty is to harmonise the operations of the subsidiary with those of the other enterprises in the pharmaceutical field with regard to production, export and import of drugs. This is done in accordance with the pharmaceutical industry's plan, taking into account other factors such as the safety and effectiveness of products, pricing, distribution, promotion, etc.

8.4 Quality Control System

Basically, the therapeutic groups of drugs have to be identical to Egyptian equivalents, as stipulated by the joint agreements signed between the Ministry for Industry and foreign parent companies in 1958 (Organisation of Drugs, 1988).

To ensure compliance, Squibb's products are tested locally. The main purpose of the quality control system is to provide a product into which quality is maintained at the most economical cost.

Control over Squibb Egypt's product quality is normally conducted as shown in figure 8.3, which demonstrates that the quality control system consists of several successive steps within three different sub-systems. The first sub-system starts at the Research Control Centre of Squibb Corporation, the main function of which is to identify the market position of a new product, evaluate the
product specification, assess incoming materials, follow-up the production process, carry out mechanical inspection and functional tests, check conformance to specification, and control packaging and transportation. After that, the determination of product quality takes place throughout the entire corporation. If the final testing and inspection of the product is successful, a sample is shipped off to Squibb Egypt to start production.

In turn, Squibb Egypt commences to test and produce a sample of the new type and sends it directly to the Health Ministry (Centre of Quality Control) for testing.

The final step is the Research Centre of Quality Control at the Health Ministry, which tests the new drug in relation to the needs of the Egyptian environment and international specifications. If the new drug is approved, the decision is reported to the subsidiary so that production may begin directly.
Benefits can be obtained from the above process for each side. On the corporation’s side, the quality control system might achieve an improvement in product quality and design, while Egypt will benefit from reasonable prices and good quality products.

8.5 Employment

Two Egyptian government agencies are in charge of monitoring Squibb Egypt’s employment in terms of the number of workers, their distribution, their wages and salaries and the percentage of foreign workers that should be allowed and their salaries and wages. The relevant agencies are the General Companies Administration, and the Ministry of Manpower.

Regarding the first agency, Article No. 312 of the Executive Regulation of the Companies Law No. 159 of 1981 stipulates that the General Companies Administration must monitor foreign subsidiaries with regard to employment. In this connection, Squibb Egypt must submit its annual employment report indicating the actual number of workers compared with that budgeted, distributed according to their positions, and total actual salaries and wages compared with those planned, enclosing details about the wages and salaries of both the Egyptian and foreign workers. An example of the employment report sent by the subsidiary to the General Companies Administration at the end of each financial period is given in figure 8.4.

The Administration carefully investigates this report
Figure 8.4

**SQUIBB EGYPT**
**FINANCE DIVISION**

**EXPENSES BUDGETARY CONTROL**

<table>
<thead>
<tr>
<th>DIVISION</th>
<th>DEPARTMENT</th>
<th>R. C.</th>
<th>PERIOD</th>
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<td>L. ESTIM.</td>
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<td>ACTUAL</td>
<td>%</td>
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<td>115 Salesmen &amp; Detailmen</td>
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<td>125 Clerical</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>130 Indirect Labour</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>135 I. Labor Performed by D. Labor</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>210 Overtime</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>225 Annual Leaves</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>240 Bonus</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>250 Social Insurance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>255 Medical Insurance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>265 Work Permits</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

S. TOTAL
in order to ensure that the proportion of foreign workers and employees is no more than 10 percent of the total employment at the subsidiary. In addition, the General Companies Administration is entitled to examine Squibb Egypt’s employment report in order to check the amount of wages paid to foreign workers, which should not exceed 25 percent of the total wages and salaries of the subsidiary.

In this respect, article No. 174 of Law No. 159 of 1981 states that:

"The number of Egyptian workers in Egypt in the companies ruled by the present law should not be less than 90% of the manpower in it, and their earnings not less than 80% of the total of wages paid by the company to its workers".

In addition to the above, article No. 175 of the above law stipulates that:

"The number of professional and administrative Egyptian workers in the companies working in Egypt must not be less than 75% of the total of workers in them and the total of their earnings not less than 70% of the total of the wages and salaries paid by the company to these categories of workers".

Based on the above statements, table 8.2 explains the position of the subsidiary’s employment, compared with the government employment policy. This table breaks down labour force and their wages into professionals, administrative and other workers. The professionals category represents the skilled labour employed in the subsidiary, while the administrative and other workers are classified into skilled and unskilled labour (see chapter 10).
Table 8.2
Composition of Squibb Egypt Employment during 1984-1987

<table>
<thead>
<tr>
<th>Group</th>
<th>1984</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Workers</td>
<td>Professional</td>
<td>Administrative</td>
<td>Other</td>
<td>Total</td>
<td>Average</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>No. % Wages</td>
<td>No. % Wages</td>
<td>No. % Wages</td>
<td>No. % Wages</td>
<td>No. % Wages</td>
<td>No. % Wages</td>
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<td>No. % Wages</td>
<td>No. % Wages</td>
<td>No. % Wages</td>
<td>No. % Wages</td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign</td>
<td>5</td>
<td>0.027</td>
<td>2</td>
<td>0.015</td>
<td>--</td>
<td>--</td>
<td>7</td>
<td>2.5</td>
<td>0.042</td>
<td>3.2</td>
<td>6000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Egyptian</td>
<td>77</td>
<td>0.450</td>
<td>78</td>
<td>0.418</td>
<td>117</td>
<td>0.387</td>
<td>272</td>
<td>97.5</td>
<td>1.235</td>
<td>96.8</td>
<td>3878</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>82</td>
<td>29.4</td>
<td>0.477</td>
<td>36.8</td>
<td>43.4</td>
<td>0.387</td>
<td>297</td>
<td>100.0</td>
<td>1.297</td>
<td>100.0</td>
<td>4694</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1985</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign</td>
<td>5</td>
<td>0.031</td>
<td>2</td>
<td>0.016</td>
<td>--</td>
<td>--</td>
<td>7</td>
<td>2.2</td>
<td>0.047</td>
<td>3.1</td>
<td>6757</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Egyptian</td>
<td>100</td>
<td>0.549</td>
<td>90</td>
<td>0.486</td>
<td>121</td>
<td>0.425</td>
<td>311</td>
<td>97.8</td>
<td>1.460</td>
<td>96.9</td>
<td>4697</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>105</td>
<td>33.1</td>
<td>0.580</td>
<td>38.5</td>
<td>41.9</td>
<td>0.502</td>
<td>318</td>
<td>100.0</td>
<td>1.507</td>
<td>100.0</td>
<td>4739</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1986</td>
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<td></td>
</tr>
<tr>
<td>Foreign</td>
<td>5</td>
<td>0.033</td>
<td>2</td>
<td>0.017</td>
<td>--</td>
<td>--</td>
<td>7</td>
<td>2.2</td>
<td>0.050</td>
<td>2.4</td>
<td>7223</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Egyptian</td>
<td>96</td>
<td>0.833</td>
<td>92</td>
<td>0.664</td>
<td>119</td>
<td>0.495</td>
<td>309</td>
<td>97.6</td>
<td>1.992</td>
<td>96.6</td>
<td>6446</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>Total</td>
<td>103</td>
<td>32.6</td>
<td>0.866</td>
<td>42.4</td>
<td>29.7</td>
<td>0.681</td>
<td>316</td>
<td>100.0</td>
<td>2.042</td>
<td>100.0</td>
<td>6462</td>
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<td></td>
</tr>
<tr>
<td>Foreign</td>
<td>4</td>
<td>0.034</td>
<td>1</td>
<td>0.008</td>
<td>--</td>
<td>--</td>
<td>5</td>
<td>1.6</td>
<td>0.042</td>
<td>1.7</td>
<td>8355</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Egyptian</td>
<td>92</td>
<td>0.895</td>
<td>96</td>
<td>0.697</td>
<td>125</td>
<td>0.876</td>
<td>313</td>
<td>98.4</td>
<td>2.488</td>
<td>98.3</td>
<td>7885</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Total</td>
<td>96</td>
<td>30.2</td>
<td>0.929</td>
<td>37.0</td>
<td>30.3</td>
<td>0.705</td>
<td>318</td>
<td>100.0</td>
<td>2.510</td>
<td>100.0</td>
<td>7894</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Squibb Egypt’s employment reports.

From the above table, several conclusions can be drawn:

1. The subsidiary has a high percentage of Egyptian workers to total workforce, ranging between 97.5 percent in 1984 and 98.4 percent in 1987. The average percentage is about 97.9 and 2.1 percent for Egyptian and foreign workers respectively. This reflects the degree of the subsidiary’s application of Egyptian employment policy.

2. Professional and administrative employees constitute a high proportion of total labour in comparison with other workers groups. In relation to total labour in the
subsidiary, the percentage of professionals ranged between 29.4% in 1984 and 30.2% in 1987, while the percentage of administrative workers to total labour ranged between 28.7% in 1984 and 30.5% in 1987. The total percentages of professional and administrative employees thus ranged between 58.1 percent in 1984 and 60.7 percent in 1987. On the whole, the average percentage of the professionals and administrative to total labour in the subsidiary is 60.8 percent during the period of the study. This shows that the Egyptian employment policy in this respect seems not to have been observed.

3. Egyptian workers' wages represent a high proportion of the total cost of wages in the subsidiary, with the average percentage of wages at 97.4 and 2.6 percent for Egyptian and foreign workers respectively.

4. There is a higher average level of wages for foreign workers than for local workers, the average wages of about L.E. 7084 and L.E. 5726 for foreign and Egyptian workers respectively during the period. This has been paid considerable attention by the government authorities. In May, 1986, the General Companies Administration set up a committee consisting of representatives from the Ministry of Manpower, the General Authority for Foreign Investment and ten experts from various supervising ministries to study the labour practices of foreign subsidiaries operating in Egypt. The committee's report discussed labour policies at Squibb Egypt, and the labour and skill requirements, and
recommended that the number of professional workers should be increased to the level allowed by the company law; that a significant change in wages policy in respect of Egyptian workers should be made and that the subsidiary should increase the absolute size of the labour force as much as possible in the following years. Their decision led to an increase of wages from L.E. 2.042 million in 1986 to L.E. 2.510 million in 1987. It should be noted that, by way of incentive, Squibb pays wages at a higher level than the local standard.

It thus seems clear that Squibb Egypt's labour force is under close control by the General Companies Administration to maintain the local standards of workers and wages vis-a-vis foreign investment in Egypt.

Also, the Ministry of Manpower follows-up Squibb Egypt from two angles. The first of these is the percentage of disabled workers; this has to account for 2 percent of total employment. In this context, the Ministry of Manpower exerted pressure on Squibb Egypt during 1986-1987 to raise this ratio to 5 percent. This issue was still under negotiation at the time of the field work in 1988-1989.

Furthermore, the Ministry of Manpower tries to control working hours at foreign enterprises, just as it does in the public sector, where the length of the working day is 8 hours, (48 hours weekly). In Squibb Egypt, however the employees work a five -day week, but sometimes some of them work more hours than the official working period. This is counted as overtime work.
The above analysis of employment control, suggests that the role of government control in this area is effective.

8.6 Conclusion

The administrative control techniques described in relation to Squibb Egypt in the present chapter constitute an important part of the Egyptian control system. However, the government authorities do not carry out these techniques in an effective manner because of lack of experience and understanding and lack of coordination. These techniques are implemented to ascertain whether Squibb Egypt operates according to the plans which were approved.

This chapter has discussed four major aspects of the administrative control system, each part serving the next, identifying the need for linkages between them. These elements are planning, production, quality control and employment.

It was found that the General Organisation of Drugs has the right to apply controls over Squibb Egypt's planning, production and quality control, while its employment practices are controlled by the General Companies Administration and Ministry of Manpower.
Chapter IX
Financial Performance

9.1 Introduction

Naturally, the management of Squibb Egypt is interested in monitoring the financial performance of the subsidiary at the end of each financial year. Similarly, the Egyptian government also desires to measure the economic performance of the subsidiary in order to ensure that its operations are consistent with national objectives.

This chapter therefore presents an analysis of the financial performance of Squibb Egypt. A number of financial performance measures, such as budget compared to actual performance and financial ratios, are frequently used to evaluate financial performance. Financial ratios may be more appropriate than budget comparisons for measuring performance in relation to that of the pharmaceutical industry as a whole.

Accordingly, this chapter, after reviewing the forms of financial statement prepared by Squibb Egypt, will focus on financial ratios. Two types of analysis are presented. The first is information from the financial statements in percentage terms, making it possible to compare performance as between the years under study. The second is an analysis of performance in relation to that of the pharmaceutical industry, using financial ratios. These ratios are classified into four main categories, namely:

1. operating ratios (profitability ratios) which are used to
measure the ability of the subsidiary to utilise its assets to generate revenue;

2. liquidity ratios, which measure the ability of the subsidiary to meet its debts as they fall due;

3. turnover ratios which analyse efficiency in holding assets;

4. capital structure ratios, which reflect how the assets of the subsidiary are financed.

9.2 Forms of Financial statements

As mentioned earlier, three basic financial statements are prepared by Squibb Egypt in accordance with the generally accepted accounting principles (GAAP) adopted by the Squibb Corporation in the USA. These are the balance sheet, income statement and the source and applications of funds statement. The form and note-worthy features of these statements are discussed below.

9.2.1 Balance Sheet

The balance sheet prepared by Squibb Egypt is a statement reflecting its financial position at Nov. 30 of each year. Table 9.1 shows the subsidiary’s balance sheet for the four years 1984 - 1987.

The balance sheet of the subsidiary is characterised by four main features as follows:

1. Degree of assets liquidity:

The subsidiary’s assets are presented in order of liquidity starting with the most liquid and ending with the least liquid assets.
Table 9.1
Squibb Egypt Balance Sheets
For the years 1984-1987
Value in L.E. million

<table>
<thead>
<tr>
<th></th>
<th>1984 %</th>
<th>1985 %</th>
<th>1986 %</th>
<th>1987 %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>0.070</td>
<td>0.2</td>
<td>0.020</td>
<td>0.1</td>
</tr>
<tr>
<td>Time deposits</td>
<td>0.400</td>
<td>1.7</td>
<td>19.964</td>
<td>39.6</td>
</tr>
<tr>
<td>Marketable securities</td>
<td>0.020</td>
<td>0.1</td>
<td>0.040</td>
<td>0.1</td>
</tr>
<tr>
<td>Receivables (net)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade</td>
<td>6.100</td>
<td>12.496</td>
<td>9.000</td>
<td>9.000</td>
</tr>
<tr>
<td>Intercompany</td>
<td>0.060</td>
<td>0.020</td>
<td>2.400</td>
<td>2.400</td>
</tr>
<tr>
<td>Other</td>
<td>0.310</td>
<td>0.471</td>
<td>0.493</td>
<td>0.493</td>
</tr>
<tr>
<td><strong>Total Current assets</strong></td>
<td>16.490</td>
<td>39.7</td>
<td>16.490</td>
<td>32.7</td>
</tr>
<tr>
<td><strong>Inventories</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw materials &amp; supplies</td>
<td>7.390</td>
<td>1.311</td>
<td>4.667</td>
<td>8.981</td>
</tr>
<tr>
<td>Work in process</td>
<td>2.500</td>
<td>0.750</td>
<td>2.670</td>
<td>2.670</td>
</tr>
<tr>
<td>Finished products</td>
<td>3.510</td>
<td>2.506</td>
<td>2.608</td>
<td>2.608</td>
</tr>
<tr>
<td><strong>Total Current assets</strong></td>
<td>18.628</td>
<td>33.5</td>
<td>18.628</td>
<td>36.7</td>
</tr>
<tr>
<td><strong>Property, plant, and equipment (net)</strong></td>
<td>4.983</td>
<td>6.5</td>
<td>5.610</td>
<td>11.1</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>23.611</td>
<td>100.0</td>
<td>32.727</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current Liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>0.670</td>
<td>0.160</td>
<td>0.652</td>
<td>0.652</td>
</tr>
<tr>
<td>Notes payable</td>
<td>1.512</td>
<td>0.5</td>
<td>4.049</td>
<td>4.049</td>
</tr>
<tr>
<td>Accounts payable-Intercompany</td>
<td>29.058</td>
<td>123.1</td>
<td>21.263</td>
<td>47.8</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>0.601</td>
<td>0.554</td>
<td>0.702</td>
<td>0.702</td>
</tr>
<tr>
<td><strong>Total Current</strong></td>
<td>32.241</td>
<td>136.5</td>
<td>45.707</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Long-term liabilities</td>
<td>4.670</td>
<td>19.8</td>
<td>22.400</td>
<td>44.5</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>23.611</td>
<td>100.0</td>
<td>32.727</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>Shareholder's Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital stock (N.O.A)*</td>
<td>3.147</td>
<td>3.432</td>
<td>17.022</td>
<td>27.505</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(13.300)</td>
<td>(29.310)</td>
<td>(17.749)</td>
<td>(13.1)</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>23.611</td>
<td>100.0</td>
<td>32.727</td>
<td>100.0</td>
</tr>
</tbody>
</table>

* Home Office Account.
2. Source of finance

Squibb Egypt attempts to classify its liabilities in terms of obligation period rather than the nature of financing.

3. Shareholders’ equity account:

Squibb Egypt’s capital stock account includes the amount of contributed capital that has come from the head office. The agreement between Squibb Corporation and the Egyptian government, stipulates that Squibb Egypt must have capital of at least $5 million for each financing period, after deduction of operating and capital losses.

4. Intercompay Current Accounts

These are current accounts opened in both the parent company’s and the subsidiary’s books in order to record transactions (raw materials, parts, equipments, cash loans etc.) between them. Credit balances are listed on the subsidiary’s books under current liabilities as accounts payable – intercompany, while debit balances are listed on the subsidiary’s books under current assets as receivables – intercompany.

5. Foreign Currency Translation:

All assets and liabilities of Squibb Egypt are translated at year-end exchange rates and the resulting adjustments are accumulated in shareholders’ equity.

9.2.1.1 Assets

Squibb Egypt’s assets fall into two main categories: current assets and fixed assets.

The current assets are classified into cash, marketable
securities, receivables, inventories and prepaid expenses.

Cash includes money in the form of cash funds available for use and cash in time deposit. These are stated at face value at the date of balance sheet.

Marketable securities are stated at cost or market value, whichever is lower at the date of the balance sheet.

Receivables, which are classified as trade, intercompany and other receivables, are stated at face amounts less an allowance for doubtful accounts, at the date of balance sheet.

Inventories include raw materials and supplies, work in process, and finished product. All types of inventory are stated at the lower of cost or market value. For inventory purposes, cost is determined at the time of acquisition and identified on the basis of First In, First Out (FIFO).

Prepaid expenses include insurance, interest, rents, taxes and advertising. These are stated at face amounts.

Fixed assets consist of property, plant and equipment. These are stated at historical cost less accumulated depreciation and amortisation. The cost of these assets is depreciated on the straight line method over the estimated useful life of the assets. Annual depreciation rates are 2% for buildings, 6.5% for machinery and equipment, 25% for vehicles and 25% for land improvement.

9.2.1.2 Liabilities and Shareholders' Equity

Squibb Egypt’s obligations are divided into the claims owed to local and foreign creditors and those owed to the
Squibb Corporation family. Debts owed to creditors are classified into short and long-term liabilities.

The short-term liabilities include accounts payable (local trade creditors), notes payable (credit facilities by local banks), and accounts payable - intercompany.

The long-term liabilities consist of local bank loans and bank overdrafts.

In addition to its liabilities, the subsidiary has obligations to its parent company, and these are reflected in the balance sheet as capital stock and retained earnings. The capital stock reflects the amount of capital contributed from Squibb Corporation's head office. The retained earnings account shows the accumulated profit (loss) that Squibb Egypt has earned and has retained for use in its operations instead of paying to its shareholders.

9.2.2 Income Statement

The income statement summarises the results of the company's operations during a particular period to show whether the company achieved a profit or made a loss for the period in question. Squibb Egypt's income statements for the years 1984-1987 are shown in table 9.2.

The income statement begins with the amount of sales generated by the subsidiary in the period under consideration.

Gross profit is given by subtracting the cost of drugs sold from sales. The cost of drugs sold reflects the direct costs in terms of raw materials, labour and manufacturing
Table 9.2  
Squibb Egypt's Income Statements  
for the years 1984-1987  
Value in L.E. Million

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Sales</strong></td>
<td>22.237</td>
<td>29.389</td>
<td>40.747</td>
<td>38.258</td>
</tr>
<tr>
<td><strong>Direct Cost of Sales:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Raw Material</td>
<td>22.096</td>
<td>27.456</td>
<td>35.392</td>
<td>33.487</td>
</tr>
<tr>
<td>- Labour</td>
<td>1.297</td>
<td>1.507</td>
<td>2.042</td>
<td>2.510</td>
</tr>
<tr>
<td>- Other</td>
<td>23.393</td>
<td>28.961</td>
<td>37.436</td>
<td>35.997</td>
</tr>
<tr>
<td><strong>Gross Profit (Loss)</strong></td>
<td>(1.156)</td>
<td>0.428</td>
<td>3.313</td>
<td>2.261</td>
</tr>
<tr>
<td><strong>Operating Expenses:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Marketing</td>
<td>1.670</td>
<td>1.722</td>
<td>1.831</td>
<td>1.610</td>
</tr>
<tr>
<td>- Administrative</td>
<td>1.020</td>
<td>0.605</td>
<td>0.743</td>
<td>3.770</td>
</tr>
<tr>
<td><strong>Operating Profit</strong></td>
<td>5.380</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other Income</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Profit</strong></td>
<td>6.024</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other Expenses:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Foreign Exchange</td>
<td>5.652</td>
<td>15.202</td>
<td>2.720</td>
<td>1.317</td>
</tr>
<tr>
<td>- Interest</td>
<td>0.675</td>
<td>0.821</td>
<td>2.389</td>
<td>2.183</td>
</tr>
<tr>
<td>- Other</td>
<td>0.392</td>
<td>0.134</td>
<td>0.629</td>
<td>0.134</td>
</tr>
<tr>
<td><strong>Net Profit (Loss)</strong></td>
<td>10.765</td>
<td>16.157</td>
<td>5.738</td>
<td>3.634</td>
</tr>
</tbody>
</table>

Source: Squibb Egypt's Annual Reports.
overheads (allocation of certain head office expenses). Unfortunately, the subsidiary does not disclose these expenses in its accounting reports.

From gross profit, the marketing and administrative expenses are subtracted to give operating profit. These expenses include those necessary to market the company's pharmaceuticals and salaries of its administrators. Other income, which includes revenue from disposal assets, credit interest, and others, is added to give total profit. From total profit, other expenses such as foreign exchange difference and interest are subtracted.

When all sales have been reported, and the cost of generating those sales subtracted, the result is the company's earnings before tax. Deducting taxes from this figure gives the company's net profit. Squibb Egypt's earnings before tax have been negative since it began operations in 1979.

9.2.3 Sources and Applications of Funds Statement

The third main financial statement prepared by Squibb Egypt is the sources and applications of funds statement, which shows the sources of all funds available to the subsidiary and how those funds were applied. Applications of funds are classified as purchase of assets and repayment of the subsidiary's obligations.

As shown in figure 9.1, Squibb Egypt has three main sources of finance. The first source is internal funds from retained earnings. Needless to say, this is negative and is in reality an application of funds. The second source is
funds from within the Squibb group, e.g. head office account (equity capital), and credits from various sister subsidiaries, especially those in Greece and Italy, in the form of credit on intercompany trade.

The third type of finance is from external sources, mainly provided by local and foreign loans and facilities (bank loans, overdrafts and trade credit). All this borrowing is normally guaranteed by the parent company, by means of loans and purchase agreements, so that the subsidiary is able to meet its obligations to all lenders with no limit on amount or duration. In this respect, the financial manager when interviewed on 9th Jan., 1988, stated:

"Our subsidiary has permission to borrow with head office's guarantee in a cash and/or non-cash form, either from the local market or abroad. However, as a procedural matter the creditors always look first to the subsidiary for repayment, taking into consideration the responsibility of the Corporation."

The above statement indicates the willingness of the corporation to stand behind its subsidiary to protect the reputation of the corporation as a whole. The head office has facilitated short-term loans and credit trade through an irrevocable letter of credit in favour of the National Bank, authorising the Egyptian National Bank to draw drafts on the Bank of America for sums not exceeding the total amount of the credit, to be drawn and honoured only where Squibb Egypt does not repay its loan. The result of this is that Squibb Egypt is able to obtain funds without having to engage in
exchange transactions in the local market. In the absence of this guarantee, the National Bank, together with the General Authority for Foreign Investment, would be able to impose rigid restrictions upon the subsidiary through the code of foreign investment.

Table 9.3 presents the statement of changes in the financial position of Squibb Egypt for 1984-1987.
Table 9.3
Squibb Egypt - Flow of Funds Statements
for the years 1984-1987

Value in L.E. million

<table>
<thead>
<tr>
<th>Source of Funds</th>
<th>1984</th>
<th>1985</th>
<th>1986</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Funds Provided By</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Continuing Operations:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit (Loss)</td>
<td>(10.765)</td>
<td>(16.295)</td>
<td>(2.029)</td>
<td>(0.729)</td>
</tr>
<tr>
<td>Adjustment for items not involving in the movement of Funds:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation &amp; Amortisation</td>
<td>0.207</td>
<td>0.337</td>
<td>0.444</td>
<td>0.517</td>
</tr>
<tr>
<td>Increase in investment (Stock Capital)</td>
<td></td>
<td>0.285</td>
<td>13.590</td>
<td>10.483</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Additions to fixed assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase/(decrease) in certain working capital:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>6.477</td>
<td>2.199</td>
<td>(5.559)</td>
<td>6.336</td>
</tr>
<tr>
<td>Accounts Receivables</td>
<td>3.004</td>
<td>6.497</td>
<td>3.493</td>
<td>(3.633)</td>
</tr>
<tr>
<td>Marketable Securities</td>
<td></td>
<td></td>
<td></td>
<td>9.000</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>(0.330)</td>
<td>(0.130)</td>
<td>0.157</td>
<td>1.088</td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>0.085</td>
<td>0.154</td>
<td>(1.336)</td>
<td>(2.965)</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>(1.242)</td>
<td>1.752</td>
<td>(3.889)</td>
<td>2.909</td>
</tr>
<tr>
<td>Accounts Payable-Intercompany</td>
<td>(18.578)</td>
<td>(22.459)</td>
<td>12.413</td>
<td>(1.072)</td>
</tr>
<tr>
<td>Accruals</td>
<td>(0.262)</td>
<td>0.047</td>
<td>(0.148)</td>
<td>(0.229)</td>
</tr>
</tbody>
</table>

| (10.846) | (11.940) | 5.131 | 11.234 |

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank Loans and bank overdraft (long-term)</td>
<td>(0.421)</td>
<td>(5.290)</td>
<td>(13.110)</td>
<td>0.578</td>
</tr>
<tr>
<td>Cash</td>
<td>(0.359)</td>
<td>0.123</td>
<td>19.391</td>
<td>(2.177)</td>
</tr>
</tbody>
</table>

| (0.780) | (5.167) | 6.281 | (1.599) |

Source: Tables 9.1 and 9.2.
From these statements we can make the following observations:

1. Retained earnings are excluded as internal source of finance because they are negative.

2. Funds provided by Squibb Corporation in terms of stock capital were L.E. 13.590 million in 1986 and L.E. 10.483 million in 1987, compared with L.E. 0.285 million in 1985. This sharp increase in capital was primarily attributable to the corporation's intention to offset the subsidiary's continued losses since 1979, to bring the subsidiary's financial position into line with the various sister subsidiaries, to support the subsidiary's increased production levels, and to maintain the level of capital requirement by the agreement with the Egyptian government (Interview with the financial manager, 9th Jan., 1988).

3. Funds provided by Squibb Corporation in terms of accounts payable - intercompany, increased by L.E. 18.578 million in 1984 and by L.E. 22.459 million in 1985. However, in 1986 we see a fall in the accounts payable - intercompany which is due to a reversion to long term credit in the form of bank loans and bank overdrafts and investment injected by the parent company.

4. Funds provided by long-term borrowing (bank loans and bank overdraft) represent an important source of finance during 1986-1987. However, most of these were directed to financing the subsidiary's working capital requirements rather than fixed assets.

indicating that more debts (credit facilities by local banks) were incurred than were paid off.

6. The increase in local trade creditors is relatively small, indicating that fewer credit purchases were made locally than expected. This also means that Squibb Egypt relies more on intercompany trade than on local trade creditors.

7. The cash balance of the company increased in 1986 by L.E. 19.391 million compared with L.E. 0.123 million in 1985. In 1987, the net cash balance decreased as a result of the redemption of some of the long term loans and notes payable.

8. The accounts receivable balance increased by L.E. 3.004 million in 1984, L.E. 6.497 million in 1985 and L.E. 3.493 million in 1986, indicating that credit sales exceeded collections. In contrast, the balance decreased in 1987 by L.E. 3.833 million, indicating that cash collection was greater than the value of credit sales.

9. Inventories increased by L.E. 6.477 million in 1984 and L.E. 2.199 million in 1985. However, in 1986, inventories decreased by L.E. 5.559 million, releasing internal investment for use elsewhere e.g. investment in time deposit. Once again, in 1987, the increase in inventories was relatively high, i.e. L.E. 6.336 million.

10. Regarding the working capital as whole, we notice that there was a marked decrease between 1984 and 1985. This can be explained by the fact that the current liabilities of
Squibb Egypt increased more than its current assets. In contrast, during the years 1986 and 1987 there was a steady improvement, attributable to the fact that current assets increased faster than current liabilities.

11. All in all, most of the increase in Squibb Egypt's net assets was the result of a major investment in current assets, particularly during the years 1986 and 1987. This was financed by stock capital and long term liabilities.

12. The increase in property, plant and equipment was relatively small, which indicates that additional investment was directed to the working capital instead of expenditure on fixed assets.

9.3 Techniques of Financial Analysis

This section provides an analytical appraisal of the financial performance of Squibb Egypt, in order to evaluate its strengths and weaknesses. Two techniques of financial analysis are used. The first is done by means of percentage financial statements, allowing comparison of Squibb Egypt's performance over the period under consideration.

The second technique is an analytical comparison between Squibb Egypt and the pharmaceutical industry. This takes two forms: a direct comparison of the capital structure and operational results by percentage financial statements and a comparison by means of key financial ratios.

9.3.1 Percentage Financial Statements

Percentage financial statements are particularly useful
for identifying financial trends.

9.3.1.1 Balance Sheets

Table 9.1 shows the percentage of each component of Squibb's balance sheet to total assets/liabilities, for 1984-1987.

Comparing the position of Squibb Egypt over this four-year period, several points are highlighted by the balance sheet items and percentages, as follows:

1. The subsidiary's total assets steadily increased, reflecting an improvement in the level of capital investment, in spite of losses incurred since the establishment of the subsidiary. For example, the total assets amounted to L.E. 60.891 million at the end of 1987, against L.E. 23.611 million in 1984, making an increase of L.E. 37.280 million, or 157.9% in percentage terms.

2. The percentage of current assets to total assets is higher in the subsidiary's balance sheets than that of fixed assets. This suggests that the subsidiary devoted more of its financial resources to working capital than to fixed assets. For example, in 1987, the percentage of current assets was approximately 10 times that of the fixed assets, whilst in 1986 it was eight times.

The above point has the following implications:

a) During 1984 and 1985, the subsidiary increased the relative amounts of current assets by increasing the amounts of inventories and receivables supported by borrowing in terms of accounts payable - intercompany (raw materials and supplies and informal loans) from the Corporation family,
which increased from L.E. 29.058 million in 1984 to L.E. 51.517 million in 1985; and by long-term loans, which increased from L.E. 4.670 million to L.E. 9.290 million. This was a result of the company management's decision to support the subsidiary's working capital and operations and hence to increase the rate of return on its capital.

Table 9.1 shows that net receivables doubled between 1984 and 1985. Almost all of this was accounted for by growth in trade receivables, perhaps a sign of successful market penetration.

Inventories accounts show an increase of 19.5% (L.E. 13.482-11.283) between 1984 and 1985, almost entirely accounted for by increase in raw materials and supplies and finished products. This is perhaps attributable to successful stock and production control (see chapters 8 and 10).

b) In 1986, the current assets situation was dramatically changed. The subsidiary increased the relative amounts of current assets by increasing the amounts of receivables and holding cash in time deposit, supported by extensive long-term borrowing and injection of funds into the subsidiary's capital stock. For example, in 1986 long term debt increased from its 1985 level of L.E. 9.290 million, i.e. 28.4% of total liabilities, to L.E. 22.400 million, i.e. 44% of total liabilities. This reflects the company's policy of increasing long-term debt to maintain the subsidiary in real terms on the one hand and to minimise the cost of
capital and reduce the exposure to financial and political risks on the other. In addition, the management of the parent company felt that if the subsidiary's managers were forced to meet local liabilities without easy recourse to financial help from the Corporation, they would be made more aware of operational costs and their performance would improve (interview with financial manager on 10th Jan., 1988). The advantages of this decision to Squibb included reduced costs, quicker and easier access to funds in the Egyptian market, term and interest details tailored to meet company needs, and reduced complacency on the part of local management. Another advantage of this policy is that while asset values tend to rise in a period of inflation, the loan repayments are fixed, so that in real terms, the liability decreases (interview with the Financial Manager on Jan. 10, 1988). However, this policy may threaten the financial market in Egypt by reducing the availability of funds for local enterprises.

The stock capital increased from L.E. 3.432 million, to L.E. 17.022 million in 1986. This sharp increase was basically attributable to the corporation's intention to offset the subsidiary's continued losses, to support its high working capital requirement and to maintain the level of capital required by the agreement with the Egyptian government (interview with the financial manager, 9th Jan., 1988).

However, it is surprising to note that the increase of
stock capital is not real, but is simply a decrease in the accounts payable-intercompany by the same amount. In this context, a confidential report from Squibb Egypt indicates that under the pressure of tax regulation, with a desire for high return, a portion of accounts payable-intercompany was capitalised into stock capital in 1986. Table 9.1 shows a fall off (in absolute terms) in accounts payable-intercompany from L.E. 51.517 to L.E. 39.104 million, i.e. L.E. 12.413 million, between 1985-1986, but a major increase in capital stock by L.E. 13.590 million in the same period. It would appear that Squibb Corporation's management has adopted the strategy of transfer pricing to avoid tax and increase its return cash flow by repatriating more capital than it could have done through profits, without actually sending additional capital and support and maintaining the subsidiary's capital structure.

The application of this policy by the subsidiary, under the direction of its parent company, can affect the Egyptian economy in two ways:

a) A heavy financial burden is imposed on the Egyptian foreign currency balance by the subsidiary's considerable freedom to repatriate funds to its parent (see chapters 3 & 10).

b) Under the tax regulations, the additional funds in terms of stock capital are exempted for a basic period of five years (see chapter 3).

The above points are reflected in the following:

1. Inventories reached L.E. 7.923 million in 1986, i.e.
an decrease of 41.2% from the year 1985. This decrease is perhaps related to the increase in sales from L.E. 29.389 million in 1985 to L.E. 40.747 million in 1986 and the increase in production from L.E. 31.256 million to L.E. 39.743 million in 1986 (see chapter 10, table 10.1). This considerable increase in production and sales was made possible by the existence of unused capacity in the subsidiary, and by the significant rise in local demand.

2. A further increase was made in net receivables from L.E. 12.987 million to L.E. 16.480 million in the accounting period 1985 to 1986. Proportionally there was a slow-down in the increase in trade receivables but a substantial increase in receivables-intercompany from L.E. 0.020 million to L.E. 2.400 million. This was perhaps related to the parent company's financial and marketing policies, designed to support the subsidiary to maintain the momentum of local market growth. However, if we look at inventories, our supposition of receivables-intercompany support for the subsidiary in 1986 is strengthened. The infusion of L.E. 2.400 million in 1986 is counterbalanced by a reported reduction of approaching L.E. 4.000 million in supplies inventory. This, together with a fall-off in work in progress, suggests that there was an interruption in operation, perhaps a redesign of the production system. If so, perhaps the L.E. 2.400 million in intercompany
receivables was to support the subsidiary through this period.

3. Total cash on hand and at bank (time deposits) were increased in 1986 by L.E. 19.984 million, i.e. 39.7 % of total assets, compared to L.E. 0.470 million in 1984 and L.E. 0.593 million in 1985. This increase was perhaps attributable to the company management’s aims of:

a. improving liquidity by releasing internal investment for use elsewhere, e.g. investment in time deposit in order to avoid risks. It should be noted that the liquidity ratios of Squibb, which consist of current and quick measures, moved from 0.5 and 0.3 in 1985 to 0.9 and 0.8 in 1986 respectively (see table 9.8).

b. repatriating due payments (accounts payable - intercompany) as quickly as possible by means of inflated transfer prices (interview with government official at GAFI on 25th Dec., 1987 and with the financial manager of Squibb Egypt on 16th Jan., 1988).

c. creating investment from local sources in order to minimise the exchange risk and cost of capital (interview with the financial manager on 10th Jan., 1988).

d. finding enough cash to continue the subsidiary’s operations in the period of inflation (interview with the financial manager on 16th Jan., 1988).
c) In 1987, the position changed once again. The subsidiary increased its relative amounts of current assets by increasing once again the amounts of inventories and holding marketable securities. This was supported by another great injection of capital stock, accounting for approximately L.E. 10.500 million (i.e. L.E. 27.505 - 17.022 million) between 1986 and 1987 and an increase in accounts payable from L.E. 1.852 million in 1986 to L.E. 4.817 million. The increase in capital stock was basically attributable to the parent company's intention to bring the subsidiary's financial position into line with those of the various sister subsidiaries and to strengthen its hold on the Middle East market (Interview with the financial manager on 16th Jan., 1988).

The above point has the following implications:

1) Total cash decreased to L.E. 17.807 million in 1987 from L.E. 19.984 million in 1986. This decrease is perhaps related to the decrease in notes payable and long-term loans, from L.E. 4.049 million, to L.E. 1.140 million, and long term loans from L.E. 22.400 million, to L.E. 21.822 million, during the same period.

2) The marketable securities account, was first established in 1987, at L.E. 9.000 million. This was done, under parent company direction, to develop the degree of liquidity (in 1987 current ratio was 1.2 and quick ratio was 0.9) and cash efficiency in financing
so as to obtain a higher return on capital. It is certainly true that Squibb, with a high level of liquidity, consistently pointed out that availability of locally - generated funds was a strong point in favour of its future operations. This is emphasised by the increase of other income from L.E. 2.972 million in 1986 to L.E. 6.024 million in 1987.

3) Between 1986 and 1987, there was a fall - off (in absolute terms) in trade receivables by L.E. 2.398 million (L.E 13.587 - L.E.11.189 million) and a lessening of intercompany receivables by L.E. 1.380 million (L.E. 2.400 - L.E. 1.020 million). The decline in trade receivables may have been related to the decrease in sales from L.E. 40.747 million in 1986 to L.E. 38.258 million in 1987, while the decline in intercompany receivables could mean that group support aimed at market growth had failed to produce the desired outcome.

4. Inventories amounted to L.E. 14.259 million in 1987, against L.E. 7.923 million in 1986, reflecting an improvement in the level of working capital, in spite of the continued losses of the subsidiary. Most of the increase in inventories is attributable to the increase in raw materials and supplies which amounted (in absolute terms) to L.E. 8.981 million in 1987, against L.E. 4.667 million in 1986. The increase in raw materials and supplies was basically attributable to two factors: production and marketing policies [the
subsidiary expanded its production capacity from 8 million units in 1984 to 18.500 million units in 1987 as a result of local market demand (see chapter 5) and transfer pricing manipulation (see chapter 7).

2. The increase in fixed assets was relatively small, indicating that most additional investment was basically directed to the current assets.

3. The percentage of current liabilities to total liabilities was higher in the subsidiary's balance sheet than that of long-term debt and equity during the period of study. This suggests that the subsidiary depended more on short-term liabilities than long-term and stock capital to finance its assets. For example, the percentage of current liabilities ranged between 136.5% and 161.2% in 1984 and 1985 respectively, but decreased in 1986 and 1987, to 90.8% and 77.3%. The sharp increase in 1984 and 1986 was attributable to the use of accounts payable - intercompany by parent company as main source of self-financing in order to develop and support the subsidiary's operations, obtain a higher return on capital, influence the Middle East market, and allow funds to be quickly returned by transfer pricing practices (see chapter 7).

The percentage of accounts payable - intercompany ranged between 123.1%, 157.4% of total liabilities in 1984 and 1985 respectively, but decreased in 1986 and 1987, to 77.7% and 66.0% percent respectively. This sharp decrease was attributable to the high increase in long term finance and
the injection of capital equity during the same period. This decrease was largely based on the parent company’s financial planning (interview with the financial manager on 10th Jan., 1988). From the same interview, it was deduced that the decline of accounts payable - intercompany in 1986 was for the following reasons:

a) to create a good balance in self-financing (equity and intercompany - accounts payable) by increasing stock capital and decreasing intercompany - accounts payable on the hand and maintaining the level of capital requirement by agreement with the Egyptian government;

b) to avoid tax liability in the event of government examination of documents related to intercompany - accounts payable;

c) to increase return cash flow by repatriating capital funds to the parent without actually sending additional funds.

On the other hand, long-term debt increased substantially, indicating that a large part of the subsidiary’s assets were being financed with long-term rather than short-term debt. In an interview with the financial manager, it was explained that the increase of long-term debt was increased for several reasons:

1) to minimise the cost of capital;

2) to minimise exposure to financial, economic, transactions and political risks and avoid inflation;
3) to avoid tax liability;
4) to reduce the over-reliance of the subsidiary's management on Squibb Corporation funds, thereby encouraging improved performance.

It appears from the above argument that Squibb uses local borrowing as a way of obtaining revenue and transferring it back to the parent as profits or as repayments for short-term intercompany debt which may in reality never have been made. Therefore, unless the Egyptian government looks beyond the short-term debt and long-term debt and equity figures and inquires into the relationship between them and earned surplus, the outflow funds will be increased and the financial market and balance of payments in Egypt negatively affected.

To sum up, it can be seen that although there is a general positive trend in the financial structure of the subsidiary over the period of study, most of its assets were financed with current liabilities in 1984 and 1985 and a great part were financed by long-term liabilities in 1986 and 1987.

From this one can deduce that the planning of the subsidiary's financial structure, and changes in it from time to time, in combination with high required return, depend on a number of factors; Squibb Corporation's policies, the nature of the Egyptian financial market and the process of government control. The parent company attempted to maximise rate of return on the funds entrusted to the subsidiary at minimum cost. In this context, the
subsidiary's financial manager in an interview on 9th Jan., 1988 emphasised:

"Squibb Egypt does not have full autonomy in financial decisions related to additional funds for investment and operations, for each such decision must be considered in relation to Head Office's financial strategy policy. Within certain limits, the subsidiary's management might be allowed to make local decisions on current operating requirements, though there is no clear information available regarding the extent of the subsidiary's autonomy. However, some indication may be given by the subsidiary's overall financial structure".

However, the process of government control has ignored the many ways in which the capital structure of Squibb Egypt is set up to minimise tax liability and destroy the foreign currency balance of the country. A little equity with much local long-term debt permits funds to be transferred abroad until the local debt is repaid. In other words, the Egyptian government has paid insufficient attention to re-evaluating and investigating import and export transactions and related documents, loans and their interest paid to Squibb head office and even to local financial institutions (interview with an officer at GAFI on 14th, Jan., 1988). This shortcoming significantly reduces the efficiency of the control process, and consequently contributes to the failure of the ODEP to achieve its objectives. Therefore, any change in the financial position of the subsidiary should give the Egyptian government (GAFI) cause for concern, particularly if the change which occurred was planned by the parent company.
9.3.1.2 Income Statements

A further examination of the performance of Squibb Egypt can be made by expressing the different income statement categories as a percentage of sales. From table 9.2, several observations can be made as follows:

1. Net sales of Squibb Egypt for 1987 were L.E. 38.258 million, a decline of 6.2% from 1986, though in 1985 and 1986 they had increased substantially from the previous year. This improvement in sales is not indicative of the subsidiary's efficiency, but rather of the price decisions of Squibb Corporation and GOD and increase in local demand.

2. Total operating costs during the four years under consideration are distinguished in the income statements on the basis of their direct or indirect relation to production.

3. The direct costs of sales were higher than the net sales revenue itself in 1984, while they were nearly equal to sales revenue in the following years. In 1984 the direct cost of drugs sold was 105.2% of the sales, decreasing to 94.1% percent of sales in 1987.

4. Raw materials represents the highest component of cost of sales, averaging around 91.8% of sales during the period under consideration. This is attributable to two factors; the abuse of transfer pricing, and the increase in price level of active raw materials (see chapter 7).

5. Gross profits for 1986 and 1987 were higher than in 1984 and 1985. Gross profit in 1986, and to a lesser extent in 1987, benefited from increase in the price of sales.
6. Operating expenses, which include marketing and administrative expenses, represented 12.2%, 8%, 6.3% and 14.1% of sales between 1984 to 1987. These expenses absorb a large part of the subsidiary's profits. The lower percentage relative to sales in 1986 may appear a favourable indicator; however, the actual amount increased. In 1987, a huge increase was made in administrative expenses from L.E. 0.745 million in 1986 to L.E. 3.770 million in 1987. This sharp increase was related to the service charge for studying a new organisation structure for the subsidiary, and similar research expenses (interview with the financial manager on 14th Jan., 1988). This indicates that the parent company tried to bring some return on its investment by overestimating the subsidiary's costs. This high level of expenses for administration should clearly signal to GAFI such problems as transfer pricing are occurring.

7. Other income was higher in 1987 compared with 1986 and 1986 and 1984, while it was zero in 1984. The increase in other income between 1986 and 1987 is perhaps due to the large amounts held on time deposit in 1986 and 1987 and purchase of marketable securities in 1987.

8. The relative amount of foreign exchange expenses increased significantly to 51.1% of sales in 1985, compared with 26.3 percent in 1984. This was basically attributable to the devaluation of the Egyptian pound against the US dollar from $1 = L.E. 0.83 to $1 = L.E. 1.35 in 1985 by the economic decree No. 167 of 1985 (see chapter 7).
However, it decreased during the next two years, reaching 6.7 percent in 1986 and 3.4 percent of sales in 1987.

9. It can also be seen from table 9.2 that interest expenses increased over the two years 1986-1987, due to the greater dependence on external borrowing than on capital equity.

10. A final point revealed by the percentage income statement is the very high losses of Squibb Egypt, particularly during the first two years of study. The net loss was 48.4% in 1984, increasing to 55.4% in 1985. However, it decreased to 5.0% in 1986 and 1.9% in 1987. This was due to the increase of sale prices to help offset rising costs (see chapter 7), and to decrease of foreign exchange difference.

It can be seen that total cost of sales increased relative to net sales, producing a continued negative results. From this we can conclude that Squibb Egypt did not use its assets to generate profits, but as a means of concealing returns for the benefit of its parent company by employing transfer pricing, services charges of various sorts, and research expenses which were basically determined by the parent company. Unless adequate steps are taken by the Egyptian government to control and monitor Squibb Egypt’s revenues and costs, the subsidiary’s presence could have an adverse effect on Egyptian tax revenue and other economic factors.

As we will see in the next section, percentage financial statements can also be useful in the comparison of Squibb Egypt’s status in relation to the pharmaceutical
industry as a whole, to give a fuller picture of its profitability and efficiency.

9.3.2 Squibb Egypt's Performance vs. Pharmaceutical Industry as a Whole

The focus of this section will be upon the financial performance of Squibb Egypt in relation to the aggregate pharmaceutical industry. The comparison takes two forms: a direct comparison by means of percentage financial statements in terms of capital structure and operating results and a comparison by means of key financial ratios. This comparison covers the period 1984-87.

9.3.2.1 Percentage Financial Statements

9.3.2.1.1 Capital Structure

Table 9.4 shows the balance sheets of Squibb Egypt compared with those of the aggregate pharmaceutical industry for the period 1984-1987, represented in percentages of individual assets/liabilities to total assets/liabilities.

Two important points should be borne in mind when comparing balance sheets. The first is the problem of terminology in reporting, which stems from differences in the accounting systems used. The second is the problem of classifying items in presenting the financial position. While Squibb Egypt follows GAAP, the domestic pharmaceutical enterprises follow the uniform accounting system (UAS). These differences result in technical variations when comparisons are undertaken (see Chapter 4, pp.188-189). For
public enterprises, the item of capital formation and expenditure for projects under construction is excluded from balance sheets during financial analysis, because they cannot be viewed as real fixed assets, when measuring the efficiency of the company's assets in generating profits.

To give another example, in the UAS self financing of a company includes own capital, government contribution, reserves and provisions, while Squibb Egypt's self-financing includes share capital, retained earnings, and intercompany accounts payable.

From table 9.4, several conclusions are drawn:

1. The first striking feature of the subsidiary's assets compared with those of the aggregate pharmaceutical industry is its higher percentage of current assets to total assets. While the Squibb Egypt percentages range from 83.5% in 1985 to 90.7% in 1987, those of the aggregate pharmaceutical enterprises lie between 77.8% in 1985 and 77.2% in 1987. The average percentage during the period under consideration is about 85.5 and 79.5 percent for Squibb Egypt and the whole industry respectively.

The above point has the following implications:

a) The subsidiary kept a higher percentage of inventories than did pharmaceutical enterprises generally, especially during 1984 and 1985. While the percentage of inventories for Squibb Egypt averaged 44.5% for the years 1984-1985, it averaged 25.9% for public sector and 41% for private sector i.e. 28.4% for all pharmaceutical enterprises. However, during 1986-1987 the average inventories percentage for
### Table 9.4
The Structure of Balance Sheets of Aggregate Pharmaceutical Industry Compared with Squibb Egypt

<table>
<thead>
<tr>
<th>Assets</th>
<th>Cash</th>
<th>Accounts Receivable</th>
<th>Marketable Securities</th>
<th>Inventories</th>
<th>Prepaid Expenses</th>
<th>Fixed Assets</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Years</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1984</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>44.800</td>
<td>10.5</td>
<td>73.600</td>
<td>17.1</td>
<td>119.800</td>
<td>27.9</td>
<td>110.100</td>
</tr>
<tr>
<td>Private</td>
<td>6.600</td>
<td>8.4</td>
<td>23.700</td>
<td>30.3</td>
<td>0.500</td>
<td>0.6</td>
<td>33.900</td>
</tr>
<tr>
<td>Total</td>
<td>51.400</td>
<td>10.1</td>
<td>97.300</td>
<td>19.3</td>
<td>120.300</td>
<td>23.7</td>
<td>144.000</td>
</tr>
<tr>
<td>Squibb</td>
<td>0.470</td>
<td>2.0</td>
<td>6.490</td>
<td>27.5</td>
<td></td>
<td></td>
<td>11.283</td>
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<tr>
<td>1985</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>49.800</td>
<td>10.4</td>
<td>79.900</td>
<td>16.6</td>
<td>128.800</td>
<td>26.7</td>
<td>125.700</td>
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<td>15.0</td>
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<td>0.100</td>
<td>0.1</td>
<td>43.300</td>
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<td>Total</td>
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<td>11.2</td>
<td>114.700</td>
<td>19.3</td>
<td>128.900</td>
<td>21.7</td>
<td>169.000</td>
</tr>
<tr>
<td>Squibb</td>
<td>0.593</td>
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<td>12.987</td>
<td>39.7</td>
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<td></td>
<td>13.642</td>
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<td>46.800</td>
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<td>88.900</td>
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<td>145.400</td>
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<td>140.800</td>
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<td>43.000</td>
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<td></td>
<td>49.900</td>
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<td>Total</td>
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<td>8.7</td>
<td>131.400</td>
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<td>145.400</td>
<td>21.6</td>
<td>190.700</td>
</tr>
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<td>16.480</td>
<td>32.7</td>
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<td></td>
<td>7.923</td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>26.300</td>
<td>4.4</td>
<td>97.100</td>
<td>16.4</td>
<td>155.200</td>
<td>26.2</td>
<td>169.100</td>
</tr>
<tr>
<td>Private</td>
<td>29.500</td>
<td>15.3</td>
<td>52.100</td>
<td>30.7</td>
<td></td>
<td></td>
<td>61.600</td>
</tr>
<tr>
<td>Total</td>
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<td>6.1</td>
<td>149.200</td>
<td>19.6</td>
<td>155.200</td>
<td>20.4</td>
<td>230.700</td>
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<td>29.2</td>
<td>12.647</td>
<td>20.8</td>
<td>9.000</td>
<td>14.8</td>
<td>14.259</td>
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<tr>
<th>Liab. Accounts</th>
<th>Notes Payable</th>
<th>Accounts Payable</th>
<th>Accruals</th>
<th>Long-Term</th>
<th>Equity</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years Payable</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>1984</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Public</td>
<td>13.600</td>
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<td>92.000</td>
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</tr>
<tr>
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<td>21.000</td>
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<td>11.400</td>
<td>14.6</td>
<td>5.200</td>
<td>6.6</td>
</tr>
<tr>
<td>Total</td>
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<td>6.8</td>
<td>103.400</td>
<td>20.4</td>
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<td>Squibb</td>
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<td>2.8</td>
<td>1.912</td>
<td>8.1</td>
<td>29.058</td>
<td>123.1</td>
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<td>4.3</td>
<td>89.500</td>
<td>18.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>40.100</td>
<td>35.9</td>
<td>19.700</td>
<td>17.6</td>
<td>7.500</td>
<td>6.7</td>
</tr>
<tr>
<td>Total</td>
<td>60.900</td>
<td>10.3</td>
<td>109.200</td>
<td>18.4</td>
<td>7.500</td>
<td>1.3</td>
</tr>
<tr>
<td>Squibb</td>
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<td>1.6</td>
<td>0.180</td>
<td>0.3</td>
<td>51.517</td>
<td>157.4</td>
</tr>
<tr>
<td>1986</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>24.800</td>
<td>4.7</td>
<td>95.800</td>
<td>18.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>38.500</td>
<td>27.3</td>
<td>31.300</td>
<td>22.2</td>
<td>9.400</td>
<td>6.0</td>
</tr>
<tr>
<td>Total</td>
<td>63.300</td>
<td>9.4</td>
<td>127.100</td>
<td>18.9</td>
<td>8.400</td>
<td>1.2</td>
</tr>
<tr>
<td>Squibb</td>
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<td>3.7</td>
<td>4.049</td>
<td>8.0</td>
<td>39.104</td>
<td>77.7</td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>27.600</td>
<td>4.7</td>
<td>110.300</td>
<td>18.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>47.500</td>
<td>28.0</td>
<td>33.800</td>
<td>19.9</td>
<td>9.800</td>
<td>5.8</td>
</tr>
<tr>
<td>Total</td>
<td>75.100</td>
<td>9.9</td>
<td>144.300</td>
<td>18.9</td>
<td>9.800</td>
<td>1.3</td>
</tr>
<tr>
<td>Squibb</td>
<td>8.817</td>
<td>7.9</td>
<td>1.140</td>
<td>1.9</td>
<td>40.176</td>
<td>66.0</td>
</tr>
</tbody>
</table>

(2) Private Companies' figures are taken from annual reports of those companies during the period 1984-1987.
(3) Squibb Egypt's figures are taken from annual reports of this company during 1984-1987.
Squibb was 19.6%, while it was 29.3% for the group i.e. 27.5% for the public sector and 35.9% for the private sector. The decline in relative amounts of Squibb's inventory was largely due to the increase in marketable securities which artificially inflated assets in 1987. The high level of Squibb Egypt's inventory, especially raw materials, is determined by the parent company's investment and production policies aimed at rapid expansion of its foreign business and for maintenance of its competitive position (interview with the financial manager on 8th Jan., 1988). However, it can be said that this level of inventory of raw materials is, to a great extent, determined in the light of transfer pricing policies (see chapter 7).

b) The subsidiary kept a higher percentage of accounts receivables than did public and private sectors during 1984 and 1985 and to a lesser extent than private sector during 1986 and 1987. While the percentage of accounts receivables averaged 33.6% for the years 1984 and 1985, it averaged 16.8% for the public sector and 30.7% for the private sector, i.e. 19.4% for the group. However, during 1986 and 1987, the average receivables percentage for Squibb was 26.7%, while it was 19.6 for the group, i.e. 16.5% and 30.6% for the public and private sectors respectively. This indicates that Squibb achieved a greater market penetration than the group. However, by close analysis, it was found that Squibb has more day's sales in receivables than the group. This suggests that the credit policy of Squibb is inefficient, compared with that of the industry (see table
9.8). Perhaps, to boost sales, Squibb offers more lenient credit terms than other enterprises of the industry.

c) As a result of the above two points, Squibb Egypt kept less cash funds, with the exception of time deposits, in relation to its liquidity, than other enterprises in the industry. Looking at the structure of the balance sheets, it can be seen that while the percentage of cash and time deposits for Squibb Egypt averaged 1.9% during 1984-1985, it averaged 10.7% for the industry as a whole. The low cash balance in Squibb between 1984 and 1985 is perhaps attributable to the following factors (Interview with the financial manager on 8th Jan., 1988): Firstly, the high relative amounts of inventory and receivables caused more cash to be tied up; Secondly, the high level of losses absorbed cash generated from sales. However it can be said that although extra sales may be profitable, they do not necessarily generate cash and thereby contribute to liquidity. The third factor is the lack of additional sources of funds. Finally, Squibb’s financial policy tries to keep cash balances at the minimum level required to support current operations.

However, during 1986-1987 the situation changed; while the percentage for Squibb averaged 34.5%, the average for all pharmaceutical enterprises was 7.8%. The improvement in cash percentage during the two years 1986 and 1987 is probably related, as stated previously, to the increase in time deposit in accordance with the substantial expansion of
long-term debt in 1986, based on management’s decision to improve the subsidiary’s liquidity and support its operations.

d) The subsidiary kept a lower ratio of fixed assets to total assets than did the industry as a whole during the period of study. This indicates that the subsidiary’s additional investment funds were directed to working capital rather than expenditure on fixed assets as was the case in the industry.

2. The second feature is the high percentage of current liabilities to total liabilities. For the period 1984-1987 this percentage was consistently higher than that of the industry, as shown in table 9.4. However, comparing current liabilities components with those of the industry, table 9.4 shows that for the period 1984-87, the percentages of accounts payable and notes payable for the industry were consistently higher than for the subsidiary. Perhaps this reflects the extent of short-term intercompany debt and materials purchased from the Squibb Corporation through open account which, as shown in chapter 7, were normally far in excess of any profit earnings or other funds repatriated by the subsidiary, making an impact on the balance of payments (see chapter 10).

3. The third feature is the low average percentage of self-financing to total assets compared with the industry as a whole. As we have seen, for the subsidiary, once again, self-financing consists of capital plus retained earnings and intercompany accounts payable. For the industry, self-
financing (equity) consists of capital, reserves, retained profit and provisions. During the period in question, the percentage of self-financing for the subsidiary averages around 57.4%, while the average for all pharmaceutical enterprises is 62.3%. These percentages are demonstrated by dividing the self-financing, for both Squibb and the group, by the total liabilities, as shown in table 9.5.

Table 9.5
Percentages of Self-Financing in Squibb and the Industry During 1984-1987

<table>
<thead>
<tr>
<th>Year</th>
<th>Squibb Egypt</th>
<th>Private Sector</th>
<th>Public Sector</th>
<th>All the Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>(13.300)+29.058</td>
<td>34.600</td>
<td>285.600</td>
<td>320.200</td>
</tr>
<tr>
<td></td>
<td>23.611 = 66.7</td>
<td>78.300 = 44.2</td>
<td>428.700 = 66.2</td>
<td>507.000 = 63.2</td>
</tr>
<tr>
<td>1985</td>
<td>(29.310)+51.517</td>
<td>42.700</td>
<td>321.600</td>
<td>364.300</td>
</tr>
<tr>
<td></td>
<td>32.727 = 67.8</td>
<td>111.700 = 38.2</td>
<td>481.500 = 66.8</td>
<td>593.200 = 61.4</td>
</tr>
<tr>
<td>1986</td>
<td>(17.749)+39.104</td>
<td>50.000</td>
<td>366.000</td>
<td>416.000</td>
</tr>
<tr>
<td></td>
<td>50.358 = 42.4</td>
<td>140.700 = 35.5</td>
<td>531.400 = 68.8</td>
<td>672.100 = 61.8</td>
</tr>
<tr>
<td>1987</td>
<td>(7.995)+40.176</td>
<td>64.700</td>
<td>408.900</td>
<td>473.600</td>
</tr>
<tr>
<td></td>
<td>60.891 = 52.8</td>
<td>169.800 = 38.1</td>
<td>592.500 = 69.0</td>
<td>762.300 = 62.1</td>
</tr>
</tbody>
</table>

Source: Table 9.4

This means that Squibb Egypt has financed approximately 40% of its assets with funds borrowed from outside the group. This debt includes short-term and long-term loans borrowed from local market.

4. The final feature is that the percentage of long-term to total assets/liabilities is also higher in Squibb Egypt than in the industry. The long-term borrowing is entirely from the Egyptian market in local as well as foreign currency. This is because most of the local financial
institutions dealing in foreign currency, are branches of foreign institutions, or investment companies established for this purpose. Data obtained about long-term debt did not show the value in foreign currency. It therefore appears that Squibb has borrowed money locally to repay short-term intercompany debt. The percentage was 19.8% in 1984, 28.4% in 1985, 44.5% in 1986 and 35.8% in 1987, compared with 8.7%, 9.3%, 9.2%, and 8.4% respectively for the industry. The average percentage was 32.1% and 8.9% for the subsidiary and the industry respectively. The difference is considerable. This high percentage in the subsidiary’s long term borrowing (compared with that of the industry) can be related to two major factors: the risk factor which motivates Squibb’s management to borrow more funds from the local market than from the foreign market and the corporation itself, and the availability of local funds and cost of capital factor, in that bank interest rates in Egypt are lower than outside Egypt (interviews with the financial manager on 10th Jan., 1988 and with the vice president of Central Bank of Egypt on 14th Jan., 1988).

The above discussion leads to three major conclusions. First, the subsidiary’s total assets increased in line with those of the industry, reflecting an improvement in the level of capital investment. However, this improvement in assets is perhaps not indicative of the subsidiary’s growth, but rather of the increase in debt (short-term and long term), the Corporation’s revaluation decision and the increase of prices for assets. Second, once again, compared
with the industry, most of the subsidiary's funds provided by both short and long-term debt were directed to financing its working capital requirements rather than fixed assets. Third, the subsidiary's ratio of self-financing to total liabilities is lower than that of the industry, reflecting the subsidiary's dependence on external sources of finance rather than self-finance. In this case, compared with the industry, the subsidiary therefore may not appear to make a positive financial contribution to the Egyptian economy. The above conclusions must give the Egyptian government cause for concern, particularly if the position which occurred was planned by the parent company.

9.3.3.1.2 Profitability

A further evaluation of the performance of Squibb Egypt compared with the aggregate pharmaceutical industry is achieved by examining the percentage income statements as shown in table 9.6. The components of cost of sales of the subsidiary and the industry are represented as a percentage of sales for the period 1984-87.

The table reveals that Squibb Egypt has a higher percentages of total costs of sales to sales. While the subsidiary's percentages were 148.4% in 1984, 155.4% in 1985, 105% in 1986 and 101.9% in 1987, those of the pharmaceutical industry were 92.3% in 1984, 91.2% in 1985, 89.8% in 1986 and 89.0% in 1987. The average percentage is about 128.7% and 90.6% percent for the subsidiary and the
Table 9.6
Operational Results of Squibb Egypt Compared with Aggregate Pharmaceutical Industry for the Years 1984-1987

<table>
<thead>
<tr>
<th></th>
<th>Sales</th>
<th>Direct Cost</th>
<th>Indirect</th>
<th>Total</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>% Raw Materials</td>
<td>% Labour</td>
<td>% Costs</td>
<td>% Costs</td>
</tr>
<tr>
<td>1984</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>244.700</td>
<td>100</td>
<td>171.400</td>
<td>60.3</td>
<td>43.600</td>
</tr>
<tr>
<td>Private</td>
<td>104.800</td>
<td>100</td>
<td>73.600</td>
<td>70.2</td>
<td>6.600</td>
</tr>
<tr>
<td>Total</td>
<td>349.500</td>
<td>100</td>
<td>245.400</td>
<td>63.0</td>
<td>52.200</td>
</tr>
<tr>
<td>Squibb</td>
<td>22.237</td>
<td>100</td>
<td>22.096</td>
<td>99.4</td>
<td>1.297</td>
</tr>
</tbody>
</table>

1985

| Public | 314.300 | 100 | 176.700 | 56.2 | 53.200 | 16.9 | 53.100 | 16.9 | 283.000 | 90.0 | 31.400 | 10.0 |
| Private | 113.300 | 100 | 80.800 | 71.3 | 7.700 | 6.8 | 18.600 | 16.4 | 107.100 | 94.5 | 6.200 | 5.5 |
| Total  | 427.600 | 100 | 257.500 | 60.2 | 60.900 | 14.2 | 71.700 | 16.8 | 390.100 | 91.2 | 37.600 | 8.8 |
| Squibb | 29.389 | 100 | 27.454 | 93.4 | 1.507 | 5.1 | 16.723 | 56.9 | 45.646 | 155.4 | (16.295) | (55.4) |

1986

| Public | 345.800 | 100 | 194.700 | 56.3 | 59.600 | 17.3 | 53.700 | 15.5 | 204.800 | 89.1 | 37.800 | 10.9 |
| Private | 135.600 | 100 | 90.100 | 66.4 | 11.800 | 8.7 | 22.300 | 16.5 | 124.200 | 91.6 | 11.400 | 8.4 |
| Total  | 481.400 | 100 | 284.800 | 59.2 | 71.400 | 14.8 | 76.000 | 15.8 | 432.200 | 89.8 | 49.200 | 10.2 |
| Squibb | 40.747 | 100 | 35.392 | 86.9 | 2.042 | 5.0 | 5.342 | 13.1 | 42.776 | 105.0 | (2.029) | (5.0) |

1987

| Public | 358.200 | 100 | 201.500 | 56.2 | 65.100 | 18.3 | 46.100 | 12.8 | 312.700 | 87.3 | 45.500 | 12.7 |
| Private | 148.700 | 100 | 94.600 | 63.7 | 13.800 | 9.3 | 29.400 | 19.8 | 128.000 | 92.8 | 10.700 | 7.2 |
| Total  | 506.900 | 100 | 296.300 | 58.5 | 78.900 | 15.6 | 75.500 | 15.0 | 440.700 | 90.0 | 56.200 | 11.0 |
| Squibb | 38.258 | 100 | 33.567 | 87.5 | 2.510 | 6.6 | 2.990 | 7.8 | 36.987 | 101.9 | (0.729) | (1.9) |

(2) Private sector's figures are taken from annual reports of those companies during the period 1984-87.
(3) Squibb Egypt's figures are taken from annual reports on this company during 1984-87.
industry respectively.

The above statement has the following implications:

a) The subsidiary pays higher prices for raw materials used in production than do other enterprises. This is because the drugs produced by Squibb Egypt are patented and also the abuse of transfer pricing. This is confirmed by the percentages given in table 9.6: for the period 1984-1987, the average percentage of raw material cost to sales is about 91.8 and 60.2 percent for the subsidiary and the industry as a whole, respectively, a considerable difference.

b) The table shows that the percentage of labour cost to sales was smaller in the subsidiary than in the whole industry throughout the period concerned. The average percentages were about 5.6 and 14.5 percent for the subsidiary and the whole industry respectively. The difference in this respect between Squibb Egypt and the aggregate industry is due, as explained by the financial manager during an interview on 9th Jan., 1988, to two main factors:

(1) The subsidiary employs a highly skilled labour force in accordance with the corporation’s employment policy.

(2) Public enterprises use far more labour-intensive production methods than Squibb Egypt, reflecting the Egyptian government’s aim to employ the largest possible number of workers in public enterprises. The use of labour intensive production methods is demonstrated by total capital employed to employed labour ratios, as shown in
Table 9.7  
Total Capital Employed to Employed Labour Ratios  

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Public sector</td>
<td>428.700</td>
<td>481.500</td>
<td>531.400</td>
<td>582.900</td>
</tr>
<tr>
<td></td>
<td>15095 = 0.028</td>
<td>15911 = 0.30</td>
<td>16468 = 0.032</td>
<td>16955 = 0.034</td>
</tr>
<tr>
<td>Squibb Egypt</td>
<td>23.611</td>
<td>32.727</td>
<td>50.358</td>
<td>60.891</td>
</tr>
<tr>
<td></td>
<td>279 = 0.084</td>
<td>318 = 0.102</td>
<td>316 = 0.159</td>
<td>318 = 0.191</td>
</tr>
</tbody>
</table>

Source: Tables 9.4 and 10.4

It can be seen from the table that the average of total capital employed to labour employed during the period in question is L.E 0.031 million for the public sector as opposed to L.E 0.134 million for the subsidiary. This confirms that national enterprises use far more labour intensive production methods than Squibb Egypt.

c) Returning to table 9.6, It is noticeable from the table that during 1984-1985 the percentage of indirect cost to sales was higher than in the aggregate industry. The percentage was 43.2% in 1984 and 56.9% in 1985, compared with 15.9% and 16.8% for the whole industry for the same years. This suggests that Squibb Egypt, because it is wholly foreign owned, seems to report higher indirect costs in order to reduce its declared profits.

d) A final point revealed by the table is the negative results of Squibb Egypt, in contrast to the positive results
of the aggregate industry. The table shows that the subsidiary's percentage of losses to sales was (48.4%) in 1984, (55.4%), (5.0%) in 1985 and (1.9%) in 1987, compared with 7.7%, 8.8% 10.2% and 11.0% for the whole industry in the same period. The huge increase of the subsidiary's losses during 1984 and 1985 was, as previously discussed, partly due to internal factors such as transfer pricing manipulation (paying higher prices for raw materials and overestimating indirect costs) to maximise repatriated funds, and partly to external factors such as low sales prices and the devaluation of the Egyptian pound against the U.S dollar. However, the decrease of these losses during 1986 and 1987 was attributable to the increase of sales prices and the huge decrease in foreign exchange differences (see table 9.2).

To summarise the results of the comparison between Squibb Egypt and the industry as a whole, significant differences were found. It was shown that Squibb Egypt paid relatively higher prices for raw materials, had higher indirect costs, and had a smaller labour cost relative to production for the period in question.

Attention is now turned to appraising the performance of Squibb Egypt in comparison with the industry as a whole by comparing financial ratios, a technique which may offer more effective analysis.

9.3.3 Financial Ratios

For convenience of analysis, the ratios have been classified into four groups to examine various aspects of
financial performance. Table 9.8 shows the calculation of the ratios for both Squibb Egypt and the aggregate pharmaceutical industry during the period of comparison.

9.3.3.1 Group 1: Measurement of Profitability

Profitability is necessary to Squibb Egypt if the Egyptian government and the parent company are to continue to support its activities. However, profitability cannot be evaluated simply by considering the annual profit (loss) figure because these figures themselves give little indication whether the subsidiary is well run and controlled, is worth investing in, or even whether it is likely to continue operating for the foreseeable future. To make judgements on these matters we need to relate the profits to other accounting dimensions.

Profitability ratios, which are shown in table 9.8, include measures of annual income such as gross profit margin, return on assets, and return on equity (net capital employed). These ratios are indicators of the subsidiary's efficiency in using the funds provided by the corporation and lenders compared with that of the whole industry.

The first ratio, net profit (loss)/sales, reveals how well a company is doing in earning a profit on each unit of sales. As can be seen from the table, while the percentage of net profit (loss) to sales has fluctuated negatively over the years of comparison, it was positive and increased steadily for the industry. For Squibb, it was (48.4) in 1984, (55.4) in 1985, (5.0), in 1986 and (1.9) in 1987,
<table>
<thead>
<tr>
<th>Table 9.8</th>
<th>Comparative Financial ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(A)</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Group 2: Profitability</strong></td>
<td></td>
</tr>
<tr>
<td>1. Net Profit margin</td>
<td></td>
</tr>
<tr>
<td>Net profit (loss)</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>22,537</td>
</tr>
<tr>
<td>2. Return on Equity</td>
<td></td>
</tr>
<tr>
<td>Net profit (loss)</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>(12,384)</td>
</tr>
<tr>
<td>3. Return on Assets</td>
<td></td>
</tr>
<tr>
<td>Net profit (loss)</td>
<td></td>
</tr>
<tr>
<td>Total Assets</td>
<td>27,611</td>
</tr>
<tr>
<td>4. Total assets turnover</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>22,335</td>
</tr>
<tr>
<td>5. Current ratio</td>
<td></td>
</tr>
<tr>
<td>Current assets</td>
<td>22,335</td>
</tr>
</tbody>
</table>

**Group 2: Activities**

| 1. Inventory turnover |                             |
| Cost of Sales | 37,092 | 41,084 | 62,778 | 26,267 | 319,700 | 290,160 | 432,200 | 418,700 |
| Inventory | 11,482 | 14,452 | 7,922 | 14,259 | 141,999 | 149,399 | 196,700 | 218,700 |
| 2. Period of asset turnover |                             |
| Accounts receivable | 8,476 | 12,309 | 16,666 | 12,667 | 37,320 | 33,740 | 56,100 | 59,000 |
| Sales/DSO | 29,236/770 | 29,236/770 | 45,767/770 | 32,209/770 | 303,500/770 | 427,000/770 | 401,400/770 | 454,900/770 |

**Group 2: Liquidity**

| 1. Current ratio |                             |
| Current assets | 18,884 | 25,857 | 41,700 | 29,312 | 613,900 | 678,700 | 540,800 | 557,900 |
| Current liabilities | 22,061 | 32,747 | 57,707 | 47,096 | 104,000 | 281,168 | 80,900 | 251,700 |
| 2. Quick ratio |                             |
| Current assets - Inventory | 5,000 | 13,550 | 34,460 | 39,656 | 200,000 | 315,800 | 310,800 | 315,600 |

**Group 2: Cashflow**

| 1. Cash ratio |                             |
| Short-term + long-term |                             |
| Liabilities | 7,061 | 18,592 | 29,922 | 26,726 | 206,900 | 220,900 | 216,300 | 259,700 |
| Total assets | 21,615 | 32,767 | 59,316 | 56,991 | 567,900 | 593,200 | 672,250 | 776,300 |

*Notes: Table 4 and 6.

*Total Accounts Payable - Intercompany accounts are excluded from short-term because they represent a part of self-financing of companies.
Table 9.8
Comparative Financial ratios

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td><strong>Group A: Profitability</strong></td>
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<tr>
<td>Net profit margin</td>
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<td>Sales</td>
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<tr>
<td>Equity</td>
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<tr>
<td><strong>Group B: Efficiency</strong></td>
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<tr>
<td>Cost of sales</td>
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<td></td>
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<tr>
<td>Inventory</td>
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<tr>
<td><strong>Group C: Liquidity</strong></td>
<td></td>
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<td></td>
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<tr>
<td>Current assets</td>
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<td></td>
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<td></td>
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<tr>
<td>Current liabilities</td>
<td></td>
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<tr>
<td><strong>Group D: Capital</strong></td>
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<tr>
<td><strong>Group E: Structure</strong></td>
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<tr>
<td>Debt ratio</td>
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</tr>
</tbody>
</table>

**Notes:**
- Data represents financial statements for the years 1984 to 1987 for both public and private sectors.
- Ratios are calculated as percents unless otherwise specified.
- Data is rounded to the nearest whole number.
- Sources: Table 9.6 and 9.7.
compared with 7.7 in 1984, 8.8 in 1985, 10.2 in 1986 and 11.0 in 1987 for the industry.

This means that the aggregate industry performed far better than Squibb Egypt. The problem with Squibb Egypt seems to lie in the high direct and indirect costs charged to drugs production. From this one can deduce, as explained by government officials during interview, that this is the result of the absence of monitoring and control by GAFI and GOD, rather than of technical variables such as volume, prices, costs, etc. It is therefore suggested that Egyptian government officials should monitor the direct costs of Squibb Egypt, especially the prices of imported raw materials, as explained in chapter 7.

The second ratio, net profit (loss)/equity, which is the rate of return on net capital employed, reflects the profitability of capital, whatever its form, supplied by the company concerned. For Squibb Egypt, the performance by this measure is dismal compared with the aggregate pharmaceutical industry. As can be seen from the same table, the percentage of rate of return on equity was (80.9%) in 1984, (55.6%) in 1985, (11.4%) in 1986 and (9.1%) in 1987 for Squibb compared with 9.4% in 1984, 10.6% in 1985, 12.1% and 12.1% in 1987 for the industry.

The third ratio, net profit (loss)/total assets, which is the rate of return on gross capital employed (total investment), reflects the overall earnings capacity of a company in relation to its total assets. As seen from table 9.8, the whole pharmaceutical industry has performed better...
than Squibb Egypt. The percentage of rate of return on assets in Squibb Egypt was (45.6), (49.8), (4.0) and (1.2) in 1984, 1985, 1986 and 1987 respectively, compared with 5.9, 6.3, 7.3, 7.4 for the industry during the same years respectively. This suggests that Squibb Egypt's management was unable to use assets efficiently to generate income during the period of study. However, it was concluded from interviews that Squibb Egypt's management found itself unable to pursue the desired outcome because it lacks autonomy in strategic financial decisions, particularly in relation to additional funds for investment and operations and the desired rate of return on investment, and because there are local constraints, which affect its decisions, such as tax regulations, price controls and rules relating to repatriation of funds (interview with the financial manager on 17th Jan., 1988).

However, the assets turnover ratio, sales/total assets, which measures the efficiency with which assets are utilised, is slightly higher on average for Squibb Egypt compared with the other pharmaceutical enterprises. It was found that, while the ratio for Squibb Egypt averaged 0.8 times for the period, it was 0.7 times for the public enterprises and 1.0 times for the private sector i.e. 0.7 times for the industry as whole. This indicates that Squibb’s efficiency in utilising its assets compares favourably with the public sector and the industry as a whole and to a lesser extent with the private sector,
despite its high and continuing losses. This suggests that the subsidiary is well run and controlled by the Corporation's financial, investment and operation policies in order to maximise repatriation of funds at low costs.

However, although the assets turnover of Squibb Egypt was quicker than that of the whole pharmaceutical industry (ratio no.4), the profit margin to sales (ratio no.1) was negative as was the overall rate of return on net and gross capital employed (ratios no.2 & 3). To improve its overall profitability, the subsidiary needs to improve its profit margins. However, it cannot do this, because it does not have full autonomy in financial decisions particularly in relation to additional funds for investment and operations. In addition, issues such as price control, shortage of foreign exchange, structure of exchange rates, availability of skilled labour, and the need to deal with several government bodies are also problematic. The above two results suggest that the control system currently operated by the Egyptian government should be re-evaluated if it wants to achieve the objectives for which the ODEP was adopted (see chapter 4), and company's operation decisions must also be re-evaluated based on the pattern which it was approved if the government wants to avoid the continuation of these high levels of losses.

9.3.3.2 Group 2: Turnover Indicators

Other indicators of Squibb Egypt's financial performance compared with that of the whole industry are the
turnover ratios. These usually consist of the sales figure as the numerator, and an asset (e.g. inventory, receivables) in the denominator. These indicators can be used to measure particular aspects of an enterprise's operational efficiency. However, attention is focused here on specific assets rather than on the overall efficiency of assets utilisation measured by the profitability ratio in the previous group.

The first ratio, cost of sales/inventory, indicates the efficiency of the enterprise's inventory management: the higher the ratio, the more efficient the management of inventory. The cost of sales was chosen and preferred because inventory is usually valued at cost.

As can be seen from the table, Squibb Egypt's inventory turnover ratio of 3.6 times on average compares very favourably with the public enterprises' average of 2.7 times and with the private enterprises' average of 2.5 times (i.e. 2.3 times on average for the whole industry) during the four years 1984-87. This suggests, at first glance, that Squibb Egypt may have more efficient inventory policies than have the public and private enterprises in its industry. However, further scrutiny reveals that the magnitude of this ratio is subject to two factors; inventory valuation methods, and cost of product sold. Squibb Egypt uses the FIFO method for inventory evaluation whereas the average cost method is used by the aggregate industry. This shows a difference in inventory amounts and cost of product sold, which may produce unreliable and misleading results in comparison
between Squibb and the industry. Therefore, it is not logical to compare the inventory turnover of Squibb, prepared on the FIFO basis, with that of the rest of the sector, which uses the average cost method. The solution to the problem may be for the government authorities to use quantities only in computation and comparison.

The next ratio, the average period of credit given, reflects the efficiency of the enterprise's policy on credit and indicates the degree of liquidity of the accounts receivable.

The average receivables collection period of Squibb was around 132 days during the period of study, while it is around 94 days for the public sector and 108 days for the private sector, i.e. 98 days for the whole industry during the same period. This means that the credit policy of Squibb Egypt is inefficient, compared with pharmaceutical industry enterprises in aggregate.

9.3.3.3 Group 3: Liquidity Indicators

Table 9.8 suggests that Squibb Egypt had low liquidity ratios compared with the rest of the pharmaceutical industry until 1985, though the situation changed afterwards, due to a great injection of funds into the subsidiary since 1986.

9.3.3.4 Group 4: Debt Ratio

Basically, the debt ratio for a wholly owned foreign subsidiary differs very much from that of a purely domestic enterprise. In the case of Squibb Egypt, diversification of
financial sources (equity capital and external borrowing) must take into account Egyptian environmental variables, such as the country's norm, availability of funds, risks, and tax considerations.

In this context, during an interview on 5th Jan., 1988, Squibb Egypt's financial manager revealed that:

"The balance of Squibb Egypt's financial structure is basically depends on the financial policy of the Squibb Corporation, Egyptian environmental factors and Law 43 of 1974 and its regulations which stipulate that debt/total assets must range between 35-40%.

The debt ratio measures the extent to which the subsidiary's total assets have been financed using funds borrowed from outside the corporation. These include short or long-term loans borrowed from Egyptian and foreign markets. Intercompany accounts payable, which are classified as current liabilities, are often regarded as a source of self-financing equivalent to equity (home office account). The debt ratio is also a measure of the financial and other environmental risks.

The debt ratio of the subsidiary during 1984-1985 was lower on average, than that required by the Egyptian foreign investment laws, being 33 percent in 1984 and 32 percent in 1985, compared with 37 and 39 percent respectively for the whole industry. This suggests that Squibb Egypt financed approximately 68% of its assets by self-financing rather than by debt during 1984-85. However, a further examination, leads to the conclusion that this is not the case. It was explained during an interview
with a government official (12 Jan., 1988) that Squibb Corporation's head office adopted a self-financing policy to make it easier for the subsidiary to expand its share and influence in the Middle East market, by making further investment in working capital. This would allow funds to be quickly transferred in either direction, by altering the credit period allowed or by transfer pricing policies.

However, in 1986 the situation changed. Squibb Egypt's management decided in accordance with the parent company's financial decision, to finance its assets mainly by using funds from the Egyptian market. This decision was based on two factors: the availability of funds in the local market at interest rates lower than those outside Egypt (interview with the financial manager on 10th Jan., 1988 and with the vice president of Central Bank of Egypt on 17th Jan., 1988), and the reduction of exposure to financial and political risks.

As a result, Squibb Egypt's debt ratio rose to 58 percent in 1986 and 47 percent in 1987, higher than allowed by the government regulation, compared with 33 percent for the whole industry in each of the two years of comparison. This was partly to avoid financial risk and partly to minimise the subsidiary's cost of capital. The financial manager of Squibb Egypt believes that financial and political risks and taxation policy in Egypt are more important factors than the cost of capital for debt ratio determination (interview on 8th Jan., 1988), partly due to
the weakness of the Egyptian financial system, and partly to the continued depreciation of Egyptian currency.

To appreciate the relative importance of the risks involved in the financing of Squibb Egypt, each of these issues is elaborated in turn.

9.3.3.4.1 Political Risk

From interviews with the subsidiary's management it appears that Egypt is perceived as a politically stable country but with the potential to cause periodic problems for foreign investment. Two factors can explain these periodic problems. The first is that the Islamic element in Egyptian politics has become stronger as a result of the People's Assembly elections, in which the fundamentalists obtained 30 seats. This fact in itself may become a threat to foreign investment at any time.

The second threat concerns Egypt's national external debt, which was estimated at $40,000 million in mid-1987. This debt is regarded as too high for comfort, although it has not yet become a political risk.

The subsidiary's management indicated that the evaluation of their prospects was not yet influenced by these factors. If it were so influenced, certain techniques might be employed to minimise political risk: for example, harmonisation with government goals, or amendment of the subsidiary's agreement with the government as a defensive measure to prevent any unfavourable actions by the government (interview with Squibb Egypt's General Manager, on 29th, Dec., 1987).
9.3.3.4.2 Financial Risk

Financial risk is concerned with the problem of fluctuations of exchange rates, which have caused large losses for Squibb Egypt, estimated, for example, at L.E. 2.720 million in 1986, and L.E. 15.202 million in 1985. The cause of these losses was the change in dollar value against the Egyptian pound, which affected the debt capital and interest paid at the prevailing exchange rate.

In fact, the regulation relating to the dollar exchange rate to be used by foreign enterprises operating in Egypt during the period 1979-1987 was altered on four successive occasions by ministerial decree. For example, during the period 1979-1981 the foreign exchange rate was roughly $1=L.E. 0.70, while from 1982 to 1984, it was devalued by almost 20% to $1=L.E. 0.83. In 1985, the Egyptian pound suffered further depreciation to $1=L.E. 1.35, and in 1987, it was devalued by almost 37 per cent to $1= L.E. 1.85. The subsidiary's management discovered that borrowing foreign currency debt on a long term basis creates considerable exposure to foreign exchange risk.

It was revealed in interviews with the financial manager that policies have been proposed by head office to protect subsidiaries from exposure to foreign exchange risk. Among these is the suggestion that the subsidiary should raise funds on the local market either by borrowing in local currency in the form of loan capital, or by taking out overdrafts, with repayment guaranteed by the parent company.
This would considerably reduce exposure in respect of debt for both the head office and the subsidiary itself.

9.3.3.4.3 Taxation

Taxation is another important factor in determining the subsidiary's debt ratio. This is because the cost of debt should be reduced by the value of the tax saving.

However, it was pointed out during interview with the financial manager, on 15th Jan., 1988, that the tax system has constrained the company's development by the stipulated depreciation rates for fixed assets and inadequate incentives. It was claimed that these factors outweigh the benefits of tax saving from debt; although a tax holiday had been available, this was seen as a limited compensation for the problems experienced. He emphasised:

"There are other factors that we consider more important than the tax holiday. Among these is the depreciation rates for fixed assets. However, since this incentive is offered to us, we try to make the most of it."

9.3.4 Movement of Funds from Squibb Egypt to Squibb Corporation

At this stage, we can say that despite the fact that Squibb Egypt's financial performance appears to have been very low, compared with the aggregate pharmaceutical industry, there is reason to suppose that this has been due to the use of transfer pricing techniques by the subsidiary in terms of paying high raw materials prices, and overestimating indirect costs to maximise repatriation of funds to the parent company. The use of these techniques is
based on the Corporation's decisions, and appears to be beyond the Egyptian government's control (interview with an official government on 20th Jan., 1988).

The size of the earnings of Squibb Egypt for a given year, after tax, depends not only on its operating results (volume, prices, costs, etc.), but also on the outflow of funds to the parent company other than profits remittance. This flow includes such items as royalties, loan repayments and interest on those loans, management fees, and payments for inventories supplied by the sister subsidiaries and the parent company.

This raises the question whether profit should constitute the difference between revenues and expenses as they appear in the subsidiary's conventional income statement, or whether it should incorporate additional hidden returns. While conventional measures of profit may be more appropriate for domestic enterprises, they are misleading in the case of Squibb Egypt.

To examine this argument, a model has been designed to determine how much money could be transferred to the parent company as a return on investment, and in what circumstances, and how the Egyptian government monitors these. In these cases, ways of transferring funds and services should be examined closely by the Egyptian government through the provisions of the foreign investment code and tax law for each type of charge. For example, whose profits are government officials measuring? Should it be profit to the corporation or the local subsidiary? Against
what investment do they measure, and do they measure before or after tax?

The flow of profits into Squibb Corporation from Squibb Egypt is depicted in figure 9.2. The chart is divided into various sources of finance. The figure is self-explanatory. However, attention is only paid to the flow of funds into Squibb Corporation from Squibb Egypt.

The previous analysis and observations from interviews clearly indicate that Squibb has the ability to decide the forms which inflow/outflow of funds should take, and what funds to repatriate. Accordingly, we can draw these conclusions from figure 9.2:

1. Concerning the flow of funds and services, it was stated during interview with an official at GAFI that Squibb Egypt is allowed to import 100% of the capital, 90% of the raw materials and all the cash short-term intercompany loans necessary for its operations, from the parent company and its sister subsidiaries. During 1984-1987, the capital assets amounted to L.E. 5.407 million on average, while the imported raw material amounted to roughly L.E. 23.737 million on average; short-term cash loans accounted for L.E. 16.227 million on average and additional investment averaged L.E. 22.263 million (see Squibb Egypt’s Financial reports 1984-1987). These issues are not controlled at all by GAFI and/or other government departments through foreign investment laws and regulations, because of lack of staff and lack of experience in dealing with such issues. To avoid
these problems we suggest that:

a) the GAFI should appoint and train additional staff, so that it can effectively exercise control over the flow of funds.

b) information and evidence about the import capital as well as raw materials and cash loans must submitted to the Authority so it can be determined whether they are within the limit of its operations as authorised by the Authority's Board in the feasibility study.

c) The GAFI should consider the possibility of using transfer pricing techniques to overstate costs.

d) The GAFI should conduct a periodic evaluation of the company, so that the need for corrective action can be promptly determined and the appropriate steps taken.

2. Royalties which accounted for 7.5% of sales, fees which accounted for 10% of sales, and transfer pricing for goods which accounted for 106% of raw materials prices (see chapter 7) play a significant part in providing Squibb Corporation with more cash funds than operational earnings, although in theory they are controlled by means of provisions of Law No.43 and its regulations, because of the difficulty of determining their market value. However, they are charges against profit, and are exempted from tax. To remedy these shortcomings, government officials need to specify as accurately as is feasible the returns specifically derived from Squibb Egypt's activity. Reported profit, therefore, should add back such things as (a) royalty payments, various service fees, and corporate
allocations charged to the subsidiary and (b) any profit on incorporate sales to the subsidiary if not made at arm’s length prices.

3. Squibb Egypt tried to reduce its overall exposure to financial risks by attempting wherever possible to (interview with an official government at GAFI on 20th Jan., 1988):

a) maintain sufficient liquidity to facilitate repatriation of funds to the parent company. For example, in 1987 percentage of current assets was approximately 10 times that of the fixed assets, whilst in 1986 it was eight times (see table 9.1);

b) depend much more on local debt than on finance from the parent company (see table 9.5);

c) speed up the payment of accounts payable - intercompany in hard currencies (interview with the financial manager on 10th Jan., 1988);

d) defer payments in local currency (interview with the financial manager on 10th Jan., 1988 and a government official at GAFI on 27th Dec., 1987);

e) raise the selling prices of drugs (see chapter 7);


It can be seen that Squibb perhaps tries to use the above policies in order to increase its return by

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repatriating more funds without investing more capital, as seen before 1986. These practices are kept beyond the reach of the Egyptian formal financial control system by artificial documentation and contrived accounting transactions; the control system is in any case ineffective (interview with an official government at GAFI On 27th Jan., 1987). To remedy this, the Egyptian government is recommended to perform its own auditing and monitoring functions, set performance standards, and to consider the likelihood of abuse of transfer pricing policies by Squibb Egypt to either overestimate or underestimate the declared profits.

4. Squibb adopts the open-account method for inventory financing, which basically represents a loan of products to the Egyptian subsidiary. This method is accepted by the code of foreign investment in Egypt. The imported raw materials amounted to L.E. 17.676 million in 1984, L.E. 21.963 million in 1985, L.E. 28.432 million in 1986, and L.E. 26.876 million in 1987. However, the control mechanisms applied by GAFI are inadequate to control these transactions. The subsidiary uses cash borrowed from local banks to pay the cost of inventory, and is thus able to increase its return by repatriating more funds without actually investing additional share capital, as seen before 1986.

5. Cash loans from head office to the subsidiary are arranged on an informal basis and in foreign currency, i.e. open-account without a fixed term of payment and without a fixed interest rate. This method is also accepted through
the code of foreign investment and is, as previously explained, ostensibly under control by the GAFI, though control is not effective. During an interview with a government official at GAFI on 29th Dec., 1987, it was stated that the subsidiary was not asked about the amount of cash loans received each year required or to provide documents about them. In addition, there was a lack of follow-up of capital structure reports which should have been submitted to GAFI for financial analysis. These loans and their interest give a greater degree of flexibility than equity for repatriation, and also give rise to tax relief in respect of interest.

Therefore, the financial control needs to be more rigid than that currently applied. The subsidiary should be required to provide clear documentary evidence of its accounts payable-intercompany and prove that cash funds received are bona-fide loans. The GAFI must examine these documents and the debt/equity ratio to make sure that the subsidiary's capital structure is well-balanced. This can be done by means of the provisions of Law 43 of 1974, by investigating the relationship of earned surplus to capital account, and the size of local borrowing, and by approving the amount of funds that may be transferred without any damage to local borrowing and the economy.

6. Tax examination, as applicable to the results of the subsidiary's operations results, is reasonably adequate, although there are some difficulties regarding the
interpretation of financial statements and the implications of accounting policies. This problem continues to command the attention of the Tax Authority and the subsidiary itself (see chapter 7).

7. The Organisation of Drugs plays an important role in controlling Squibb Egypt's activity. This is effectively done by means of quality control and price control of finished drugs (see chapter 7 & 8).

8. GAFI applies rigid restrictions concerning domestic long-term loans and credit facilities created by the subsidiary with local banks. However, one of the criticisms directed by GAFI towards Squibb Egypt's management in this situation is that they depend heavily on local debts to provide finance to cover their operating and capital losses. Additionally, information about sources of foreign loans is not disclosed.

To conclude our discussion, the financial return calculations of Squibb Egypt are based on its corporation's financial strategy decisions and the level of the existing control system applied in Egypt, and is influenced by the following factors:

1. the need of Squibb Corporation and its worldwide subsidiaries for funds;
2. the sources and costs of funds available to Squibb Egypt including those funds generated internally;
3. the effect of taxation on the various types of payment that may be undertaken and on the timing of the payment;
4. the sensitivity of the corporation's management towards exchange risks and other environmental risks;
5. the degree of local autonomy of the subsidiary;
6. Remittance regulations and restrictions on profits, royalties, fees, interest, and management charges payable to the parent company.

9.4 Conclusions

The purpose of this chapter was to appraise the financial performance of Squibb Egypt in order to determine its profitability and efficiency. This was done by two financial analysis techniques. First, percentage financial statements of the subsidiary over the 1984-1987 period were examined. Second, an analytical comparison was made between Squibb Egypt and the aggregate pharmaceutical industry. This comparison took two forms: a direct comparison of the financial statements in terms of percentages; and a comparison by means of key financial ratios.

It was concluded from these analyses that, although Squibb Egypt appears to have performed badly compared with the whole industry, there is reason to believe that the company pays high raw materials prices and overstates indirect costs to maximise repatriation of funds to the parent company. The use of these techniques is perhaps based on the Corporation's decisions, and would appear to be beyond the government's control (interview with an official government on 20th Jan., 1988).

Therefore, greater attention should be paid to Squibb Egypt's financial performance by the Egyptian government than is the case at present. The process as currently
operated has shortcomings. These shortcomings revolve around the possibility of using transfer pricing techniques and the allocation of head office's expenses to conceal the subsidiary's reported profit. The government needs to overcome these problems by means of an effective financial control system. To this end, the government is recommended to perform its own auditing and monitoring functions, to set performance standards, to evaluate the subsidiary's operation annually, to ascertain that the actual profit achieved is in accordance with the budget approved by GAFI, to compare it with profits for the whole industry, and to consider the likelihood of the abuse of transfer pricing technique to understate reported profits.
Chapter X
Economic performance

10.1 Introduction

To complete the general picture of Squibb Egypt’s performance, this chapter provides an appraisal of its contribution to the Egyptian economy. The first aspect of the analysis is a direct comparison between Squibb Egypt and the aggregate pharmaceutical industry in terms of production and employment, the second is a consideration of Squibb Egypt’s effect on the balance of payments. This chapter therefore deals with three major features of Squibb Egypt’s contribution to the Egyptian economy: production and value added, employment, and contribution to the balance of payments.

10.2 Production

Table 10.1 shows the development of Squibb Egypt’s production in comparison with that of the aggregate industry, represented by two indicators: the rate of growth of production, and its share of production as a percentage of the total production of the industry during 1984-1987.

From the above table, the following conclusions can be drawn:

1. The total production of the industry grew at a relatively high rate in 1985. Squibb Egypt had by far the greatest rate of increase: more than twice that of the public enterprises, and more than three times that of the private enterprises. However, the overall rate of growth
### Table 10.1
Development of Squibb's production in comparison with the Aggregate pharmaceutical Industry, valued at existing ex-factory prices

(Based on 1984 value in millions)

<table>
<thead>
<tr>
<th>Years</th>
<th>Rate of Growth %</th>
<th>Relative Weight %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public</td>
<td>284.651</td>
<td>328.602</td>
</tr>
<tr>
<td>Private</td>
<td>110.152</td>
<td>122.700</td>
</tr>
<tr>
<td>Total</td>
<td>394.803</td>
<td>451.302</td>
</tr>
<tr>
<td>Squibb Egypt</td>
<td>23.082</td>
<td>31.256</td>
</tr>
<tr>
<td>Grand Total</td>
<td>417.885</td>
<td>482.558</td>
</tr>
</tbody>
</table>

(2) Production figures for the private companies are taken from balance sheets of all enterprises, during the period 1984-1987.
(3) Production figures of Squibb Egypt are from its annual reports during 1984-1988.

decreased from 15.5% in 1985 to 13.2% in 1986, and to 7.1% in 1987. This occurred as a result of the increase in unused production capacity in the public sector and Squibb Egypt as result of the reduction in raw material imports, and by a significant increase in the total demand for imported drugs (interview with a government official, 15th Jan., 1988).

A significant aspect of Squibb Egypt in relation to the industry is its high growth rate. Its production grew enormously for the first two years, much faster than that
of the aggregate industry. However, the production rate then declined dramatically, decreasing by 3.5% in 1987. This was due mainly to the reduction in the inventory of imported raw materials, in accordance with the corporation's policy, the previous year (Interview with financial manager, 9th Jan., 1988). Figures of inventory in the balance sheets (chapter 9, table 9.1) confirmed that the balance of raw materials declined from L.E. 8.591 million in 1985 to L.E. 4.667 million in 1986. On average, Squibb Egypt's annual rate of growth over the period was 19.7 percent, compared with 11.5 percent for the industry.

Another feature of Squibb in relation to the industry is its share of the industry's production. Although Squibb's percentage of total production was small over the period of study, it increased from 5.5 percent in 1984, to 6.6 percent in 1987. This growth in production can be related to two major factors. The first is the availability of active ingredients for production, which are patent brands belonging to the Squibb Corporation. The second is the rise in local demand for Squibb's drugs, especially general anti-infectives (antibiotics, anti-TB and antileprotics, and cardiovascular drugs). In the absence of such demand, it would not have been able to expand its production to the level of 18 million drugs in 1988, expected to increase to 20 million in 1990. The third factor is government encouragement because of the shortage of foreign exchange for drug imports (Interview with the financial manager, 9th Jan., 1988).
To summarise, it can be seen that although Squibb’s share of production in relation to the industry was small, its growth rate of production has been significant, reflecting a considerable increase in sales and decrease in losses during the period in question (see chapter 9 table 9.2). This considerable increase in production was due to the existence of unused capacity in the company, the availability of active ingredients for production from the parent company, and the rise in local demand. Thus, growth has still occurred in a loss-making period.

10.3 Value Added

Table 10.2 shows the calculation of both gross and net value added for Squibb Egypt and for the whole industry, indicating the rate of value added to the output of these enterprises. An important point should be borne in mind when comparing value added. Squibb Egypt’s net value added was calculated after subtracting raw material costs, other costs and services bought outside the industry, depreciation and foreign payments such as royalties, fees etc. This is because Squibb Egypt is a wholly foreign-owned subsidiary which transfers such payments outside Egypt. However, the aggregate industry’s net value added was calculated after subtracting costs of raw materials and services, and depreciation.
Table 10.2

Squibb Egypt's Value Added Compared with that of the Aggregate Pharmaceutical Industry

<table>
<thead>
<tr>
<th>Items</th>
<th>Squibb Egypt</th>
<th>Aggregate Pharmaceutical Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1984 %</td>
<td>1985 %</td>
</tr>
<tr>
<td>Output</td>
<td>22.849</td>
<td>30.569</td>
</tr>
<tr>
<td>(-)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Input*</td>
<td>22.873</td>
<td>27.971</td>
</tr>
<tr>
<td>Gross value</td>
<td></td>
<td></td>
</tr>
<tr>
<td>added (0.024)</td>
<td>0.207</td>
<td>0.337</td>
</tr>
<tr>
<td>Depreciation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Royalties</td>
<td>1.669</td>
<td>2.904</td>
</tr>
<tr>
<td>Fees</td>
<td>0.017</td>
<td>0.019</td>
</tr>
<tr>
<td>Interest</td>
<td>0.600</td>
<td>0.821</td>
</tr>
<tr>
<td>Net value</td>
<td></td>
<td></td>
</tr>
<tr>
<td>added (2.517)</td>
<td>9.000</td>
<td>10.900</td>
</tr>
</tbody>
</table>

(2) Private enterprises' figures are taken from their annual reports.
(3) Squibb Egypt's figures are taken from its annual reports.

* Input of Squibb Egypt comprises raw materials, packaging material, other costs and services bought outside the industry.
* Input of the whole industry include commodity requirements, services acquired, the purchase cost of finished goods purchased for sale, customs duties and other taxes.
* The net value added for the whole industry is calculated in accordance to the form adopted by the uniform accounting system (see chapter 1).

From the above table, several conclusions can be drawn:
1. Percentage gross value added to output for Squibb Egypt increased significantly as compared with the whole industry during the period of study. Growing from (0.1) percent in 1984, Squibb's value added reached 8.4 percent in 1987, compared with 31.6 percent and 30.9 percent for the industry.
in the same period. This is because the subsidiary recorded a high growth rate in output. Nevertheless, this percentage of gross value added is very modest as compared with the aggregate industry. The main reason is that the percentage of raw material costs of Squibb Egypt is relatively higher than that of the industry (see chapter 9 table 9.6) and this is reflected in the increase in output.

2. The percentage of net value added to output has been steadily improving for Squibb Egypt whereas, despite two years of increase, it declined overall for the industry during the same period. This decline is attributable to the production capacity which became idle over this period and the shortage of imported raw materials. While Squibb Egypt's percentages were (11.0) percent in 1984, (4.8) percent in 1985, (4.1) percent in 1986 and (3.1) percent in 1987, those of the whole industry were 29.3% in 1984, 32.7% in 1985, 31.7% in 1986 and 28.5% in 1987. The average percentage was about (5.8) and 30.6 percent for Squibb Egypt and the industry respectively.

3. The net value added in absolute terms and in its ratio to output was negative for Squibb, but positive for the aggregate industry during the period of comparison. This is due partly to the overpricing of raw materials imported and the amount of funds transferred abroad, and partly to government restrictions on the prices of the final products.

To summarise, it can be seen that the rate of net value added to output for Squibb Egypt in the four years 1984-1987
is particularly poor, compared with the group, due to the increase in the cost of raw materials, and to government restrictions on the prices of the final products.

10.4 Employment

One of the standard arguments in support of Squibb Egypt's operation in Egypt is that it would create new jobs. This section attempts to measure to what extent Squibb Egypt contributed to the creation of new jobs compared with the aggregate pharmaceutical industry during the 1984-87 period. The appraisal takes two forms: a direct comparison of the pattern of employment and a comparison by means of rate of growth and relative weight of total employment in the industry.

With regard to the first basis of comparison, table 10.3 indicates the pattern of Squibb Egypt's labour force compared with that of the aggregate pharmaceutical industry in terms of skilled and unskilled workers.

It can be seen that Squibb Egypt employed a far greater proportion of highly skilled personnel, and far less labour compared with the aggregate pharmaceutical industry. The skilled labour categories include top management, professional, intermediate and other skilled groups. While the percentage of skilled workers employed by Squibb was 86.7 percent in 1984 and 88.4 percent in 1987, for the aggregate pharmaceutical industry the figures were 33.0 percent in 1984 and 34.9 percent in 1987. The average percentage during the period was about 88.1 and 35.2 percent for Squibb Egypt and the aggregate industry respectively.
## Table 10.3
Composition of Squibb Egypt’s Employment Compared with that of The Aggregate Industry, 1984-1987

<table>
<thead>
<tr>
<th>Group of workers</th>
<th>Squibb Egypt</th>
<th>Aggregate Pharmaceutical Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
</tr>
<tr>
<td>Top Management</td>
<td>8</td>
<td>2.9</td>
</tr>
<tr>
<td>Professional</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medicine</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Pharmacy</td>
<td>10</td>
<td>12</td>
</tr>
<tr>
<td>Chemistry</td>
<td>11</td>
<td>6</td>
</tr>
<tr>
<td>Marketing</td>
<td>42</td>
<td>63</td>
</tr>
<tr>
<td>Other</td>
<td>12</td>
<td>16</td>
</tr>
<tr>
<td></td>
<td>81</td>
<td>29.0</td>
</tr>
<tr>
<td>Intermediate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial</td>
<td>17</td>
<td>16</td>
</tr>
<tr>
<td>Commercial</td>
<td>21</td>
<td>21</td>
</tr>
<tr>
<td>Other</td>
<td>16</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>54</td>
<td>19.4</td>
</tr>
<tr>
<td>Other Skills</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technical</td>
<td>85</td>
<td>108</td>
</tr>
<tr>
<td>Non-technical</td>
<td>14</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>99</td>
<td>35.5</td>
</tr>
<tr>
<td>Total</td>
<td>242</td>
<td>86.7</td>
</tr>
<tr>
<td>Unskilled</td>
<td>37</td>
<td>13.3</td>
</tr>
<tr>
<td></td>
<td>11130</td>
<td>67.0</td>
</tr>
<tr>
<td>Grand Total</td>
<td>279</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>17387</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual Wages &amp; Salaries</th>
<th>A.V.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4649</td>
</tr>
<tr>
<td></td>
<td>4739</td>
</tr>
<tr>
<td></td>
<td>6462</td>
</tr>
<tr>
<td></td>
<td>7894</td>
</tr>
<tr>
<td></td>
<td>3142</td>
</tr>
<tr>
<td></td>
<td>3503</td>
</tr>
<tr>
<td></td>
<td>3976</td>
</tr>
<tr>
<td></td>
<td>4274</td>
</tr>
</tbody>
</table>

This great difference in the comparative distribution of professionals between Squibb Egypt and the aggregate industry is to a very large extent due to the policy of the Squibb Corporation, which seeks to employ the largest possible number of professionals in Squibb Egypt to support the high level and methods of production.

It is also noticeable from the table that the percentage of workers in the intermediate skills group was comparatively close for the subsidiary and the whole pharmaceutical industry. While the percentage of the intermediate group for Squibb Egypt averaged 14.1 for the four years, the average for the whole industry was 11.5 percent.

As in the case of the professionals, the percentage of technical and non-technical skilled workers was considerably higher in Squibb Egypt than in the aggregate industry: 35.5 percent in 1984, increasing to 40 percent in 1987 for Squibb, compared with 15.0 percent in 1984 and 13.2 percent in 1987 for the whole industry. This was emphasised by the personnel manager (interview on 15th Jan., 1988) who explained that the subsidiary always attracts people with previous experience in the pharmaceutical industry, gained through working in domestic enterprises.

Finally, while the subsidiary's average percentage of unskilled labour was 11.9 percent, the average for the industry was 64.9 percent. This disparity reflects to a very large extent the policy of the Egyptian government which seeks to employ the largest possible number of workers in
nationalised enterprises.

It is also surprising to find that on average Squibb Egypt paid much higher wages for workers than did the industry as a whole. This is basically because Squibb has a higher proportion of professional and skilled workers than has the industry. While average wages of workers in Squibb Egypt ranged from L.E. 4649 in 1984 to L.E. 7894 in 1987, those of the aggregate pharmaceutical industry lay between L.E. 3142 in 1984 and L.E. 4274 in 1987. This gives a significant indication that the Egyptian government must change its wages and salaries policy in respect of local enterprises' workers.

In relation to the high percentage of skilled labour, the subsidiary's personnel manager emphasised that Squibb Egypt has better systematic training programmes than local enterprises. All workers have to undergo training, either at Squibb Egypt or at Squibb Corporation training centres in Italy, Belgium and the U.S.A. Professionals, top management and engineers are trained at the Corporation's training centres, while the rest are trained at Squibb Egypt. The training programme is considered to be important in order to improve productivity and raise production efficiency. Squibb Egypt does not have a separate training centre, but has a small organisational unit belonging to the personnel division, run by five people from head office together with three from the subsidiary itself. The main contents of the training programmes are technical and professional skills,
job instruction and safety, and language and technical information (Interview on 15th Jan., 1988).

The types of training programme depend on the nature of the work carried out by the trainees, as does the length of the training programme. For example, the subsidiary trains skilled workers for three months in manufacturing methods for Squibb's new drugs, and the technology and machinery used at the subsidiary. For clerical workers, the training programmes concentrate on the U.S.A. accounting system. It is felt that even though some employees may have previously trained elsewhere, the training programmes are needed to give them greater insight into new methods and techniques used at the subsidiary.

It can thus be concluded that Squibb Egypt employs much more skilled labour and pays much higher wages on average, than does the industry.

With regard to the second aspect of comparison, table 10.4 shows analyses of Squibb Egypt's employees and their wages, represented in two ways: the development of the subsidiary's employment compared with that of the industry, and the contribution of the subsidiary's employment as a percentage of the aggregate industry's employment, for the period 1984-1987.

It can be seen that the change in the number of employees differs significantly between Squibb Egypt and the aggregate industry during the period. In 1985 the number of Squibb's employees rose by 13.9 percent, compared with 4.7
percent for the industry as a whole. However, in 1986 there was a 0.7 percent drop in Squibb Egypt's employment, compared with a 3.2 percent increase for the aggregate industry. However, the rate once again increased by 0.6 percent for Squibb Egypt in 1987, while it decreased by 2.8 percent for the whole industry in the same period. On the whole, the average annual rate of growth of the subsidiary's employees during the four years period is higher than that of the group.

Table 10.4
The Development of Squibb Egypt's Employment in Comparison with Aggregate Pharmaceutical Industry, 1984-1987

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. No. of Labour Force</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public</td>
<td>15095</td>
<td>15911</td>
<td>16468</td>
<td>16955</td>
<td>89.4</td>
<td>89.9</td>
<td>90.1</td>
<td>90.3</td>
<td>5.4</td>
<td>3.5</td>
<td>2.9</td>
<td></td>
</tr>
<tr>
<td>Private</td>
<td>1517</td>
<td>1476</td>
<td>1489</td>
<td>1507</td>
<td>8.9</td>
<td>8.3</td>
<td>8.1</td>
<td>8.0</td>
<td>(3.3)</td>
<td>0.8</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>16612</td>
<td>17387</td>
<td>17957</td>
<td>18462</td>
<td>98.3</td>
<td>98.2</td>
<td>98.3</td>
<td>98.3</td>
<td>4.7</td>
<td>3.2</td>
<td>2.8</td>
<td></td>
</tr>
<tr>
<td>Squibb Egypt</td>
<td>279</td>
<td>318</td>
<td>316</td>
<td>318</td>
<td>1.7</td>
<td>1.8</td>
<td>1.7</td>
<td>1.7</td>
<td>13.9</td>
<td>40.7</td>
<td>0.6</td>
<td></td>
</tr>
<tr>
<td>Grand Total</td>
<td>16891</td>
<td>17705</td>
<td>18273</td>
<td>18780</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>4.8</td>
<td>3.2</td>
<td>2.8</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public</td>
</tr>
<tr>
<td>Private</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Squibb Egypt</td>
</tr>
<tr>
<td>Grand Total</td>
</tr>
</tbody>
</table>

A second observation is that the relative shares of the sector's employment, are almost constant during the period of comparison.

At the same time Squibb's rate of change of wages was consistently higher than that of the industry.

Finally, the subsidiary's contribution to total wages in the industry increased during the period from 2.4% in 1984 to 3.0% in 1987. The average percentage is about 2.7 % and 97.3% for the subsidiary and the group respectively.

The above analysis shows that though Squibb Egypt might have contributed less than expected to employment in Egypt, its contribution was generally better than that of other competing enterprises. However, it may be said that domestic enterprises are capable of producing better results in the employment field, because they are under government pressure to employ a far greater number of workers than are foreign subsidiaries.

10.5 Effects of Squibb Egypt on the Balance of Payments

One of the principal aims of allowing the entry of the Squibb subsidiary into the Egyptian market was that it would increase pharmaceutical exports and reduce imports, leading to gains in tax and foreign exchange earnings. However, in the light of the available data on its performance, it seems that Squibb had a detrimental effect on the balance of payments for the period 1984-87.

In this context, the main purpose of this section is to measure the real influence of Squibb Egypt's operations
on the Egyptian balance of payments in terms of exchange earnings, export and import substitution.

10.5.1 Foreign exchange

The foreign exchange earnings of Squibb Egypt constitute an important element that may positively or negatively affect the balance of payments deficit. In this respect, we adopt the formula used in the case studies by Lall and Streeten (1977, p. 130) to judge the extent of Squibb Egypt's influence on the balance of payments:

\[ B_d = (X+I) - (C_k + C_r + R + D) \]

Where, in any period:

- \( B_d \) = the direct balance of payments effects of an enterprise;
- \( X \) = f.o.b. value of exports;
- \( I \) = inflows of equity capital and loans from abroad, including earning retained out of profits, net of capital and loans repatriated;
- \( C_k \) = c.i.f. value of capital goods imported;
- \( C_r \) = c.i.f. value of raw material and intermediate goods imported (excluding finished goods imported for resale);
- \( R \) = royalties and technical fees paid abroad after tax;
- \( D \) = value of net after-tax profits and interest accruing abroad, including retained earnings.

In accordance with this equation, table 10.5 shows that the direct effects of Squibb Egypt on the Egyptian balance of payments in term of foreign exchange earnings were negative for the entire period under review.

The subsidiary's foreign exchange impact, expressed as a percentage of sales for the period of study, was (93.0) percent in 1984, (87.7) percent in 1985, (26.5) percent in 1986.
Table 10.5
The Direct Balance of Payments Effects of Squibb Egypt’s Foreign Exchange Earnings, 1984-1987

<table>
<thead>
<tr>
<th>Year (1)</th>
<th>(X+I) Total Value in L.E. million</th>
<th>C_k (2)</th>
<th>C_r (3)</th>
<th>R (4)</th>
<th>D (5)</th>
<th>B (1-(2-5)) as percentage of sales</th>
<th>Total (1-2-5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>0.135 0.861</td>
<td>0.135</td>
<td>17.676</td>
<td>1.686</td>
<td>0.600</td>
<td>20.823 (20.688) (93.0)</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>0.085 0.427</td>
<td>0.285</td>
<td>21.963</td>
<td>2.923</td>
<td>0.821</td>
<td>26.134 (25.764) (87.7)</td>
<td></td>
</tr>
<tr>
<td>1986</td>
<td>8.111 0.149</td>
<td>13.590</td>
<td>21.701</td>
<td>0.149</td>
<td>28.432</td>
<td>3.080 0.839 32.500 (10.799) (26.5)</td>
<td></td>
</tr>
<tr>
<td>1987</td>
<td>10.280 0.119</td>
<td>10.483</td>
<td>20.763</td>
<td>0.119</td>
<td>26.567</td>
<td>2.897 0.935 30.518 (9.755) (25.5)</td>
<td></td>
</tr>
</tbody>
</table>

Source: Squibb Egypt’s various financial Reports.
Notes: We excluded retained earnings from our calculation because of the continuing losses of the subsidiary.

and (25.5) percent in 1987 respectively, suggesting that a reduction in the adverse influence during the last two years of the study. This was due partly to the growth of exports from just L.E. 0.135 million in 1984 to L.E. 10.285 million in 1987 and partly to the increase of capital inflow from nil in 1984 to 10.483 million in 1987.

The above analysis of the contribution of Squibb Egypt to foreign exchange earnings indicates that the subsidiary has had a detrimental influence on the balance of payments in Egypt.

10.5.2 Export Performance

With regard to export performance, the actual exports of Squibb Egypt, compared with those of the whole industry, have varied considerably.
Table 10.6 shows the actual drug products of Squibb Egypt that have been exported, represented in two ways: the development of the subsidiary's exports as a percentage of sales and the actual exports of the subsidiary as a percentage of the whole industry's exports, for the period 1984-1987.

Table 10.6
Squibb Egypt's Exports Development, 1984-1987

<table>
<thead>
<tr>
<th>Year</th>
<th>Industry Exports (Actual)</th>
<th>Exports of Squibb Egypt</th>
<th>Sales of Squibb Egypt</th>
<th>As Percentage of Industry's Exports</th>
<th>As Percentage of Squibb Egypt Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>4.200</td>
<td>0.135</td>
<td>22.237</td>
<td>3.2</td>
<td>0.6</td>
</tr>
<tr>
<td>1985</td>
<td>1.440</td>
<td>0.085</td>
<td>29.389</td>
<td>5.9</td>
<td>0.3</td>
</tr>
<tr>
<td>1986</td>
<td>30.040</td>
<td>8.111</td>
<td>40.747</td>
<td>27.0</td>
<td>19.9</td>
</tr>
<tr>
<td>1987</td>
<td>40.793</td>
<td>10.280</td>
<td>38.258</td>
<td>25.2</td>
<td>26.8</td>
</tr>
</tbody>
</table>


The planned export rate, according to Squibb's feasibility study was 75% of sales annually. However, the actual percentage of exports in relation to sales was only 0.6 percent in 1984, decreasing to 0.3 percent in 1985. The failure of the subsidiary to export at the rate envisaged by the feasibility study during 1984 and 1985 can be attributed to the Arab boycott instituted in 1978 in protest against the Camp David treaty between Egypt and Israel (interview with financial manager on 10th Jan., 1988).
In 1986, the position changed. 1986 and 1987 showed considerable increases, exports reaching 19.9% and 26.8% respectively of net sales. This increase was largely attributed to the special relationship of the subsidiary's manager with the British government, which imported pharmaceuticals estimated at L.E. 8 million in 1986 and L.E. 9.5 million in 1987 (Ibid). The main export products were antibiotics (Velosef - Dexacillin), cardiovascular drugs, corticosteroids and psychotropics.

It can also be seen from the table that Squibb Egypt's share in the total exports of the pharmaceutical sector was 27 per cent in 1986, as compared with only 3.2, and 5.9 per cent in 1985 and 1984 respectively. However, this percentage decreased to 25.2 percent in 1987.

It can be concluded that Squibb Egypt has failed to achieve the export rate envisaged in its feasibility study. This failure has been attributed to a number of factors, among them, the Arab boycott, and the lack of government control.

10.5.3 Import Substitution

To complete the evaluation of Squibb Egypt in terms of its effect on the balance of payments, we shall examine import-substitution, measuring the direct effects of Squibb Egypt on the balance of payments by reducing imports of drugs and saving foreign currency. This cannot be measured in terms of the prevailing price level for drugs, due to the difference between the pricing policy adopted by the
Organisation of Drugs which fixes prices according to the medical necessity of different pharmacological groups of drugs, and the international prices quoted for trade.

What can be done is to take a rough measure of the opportunity cost of drugs produced by the Squibb subsidiary in Egypt, both in terms of the price of imported drugs and in terms of the cost of drugs production compared with the Egyptian equivalent. In this context, we can take a formula used by the Institute of National Planning - Egypt (Industrial Planning Centre) in several case studies as follows (Elkhalawy, 1986):

\[ B = (S + E) - (M + D) \]

Where:

- **B** = is the net contribution to balance of payments.
- **S** = is the value of local sales of the Squibb Egypt during the period of study which is expressed by import substitution.
- **E** = is the value of actual export of the subsidiary.
- **M** = is the total C.I.F. cost of imported raw material.
- **D** = is the depreciation of imported equipment necessary for a year's production of the volume of drugs imported.

If we now calculate the above equation for the subsidiary, we can arrive at the actual effects on the balance of payments as shown in table 10.7 below.

It thus seems that the saving in domestic production by Squibb Egypt is favourable to the balance of payments in terms of import substitution policy, if we do not take into consideration such additional costs as royalties and overpriced raw materials.
Table 10.7
The Effects of Squibb Egypt Production
On Import Substitution, 1984-1987

(Value in L.E. Million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Local sales (S)</th>
<th>Actual exports (E)</th>
<th>(1+2)</th>
<th>Raw material imported (M)</th>
<th>Depreciation (D)</th>
<th>(4+5)</th>
<th>(3-6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>22.102</td>
<td>0.135</td>
<td>22.237</td>
<td>17.676</td>
<td>0.207</td>
<td>17.883</td>
<td>4.354</td>
</tr>
<tr>
<td>1985</td>
<td>29.304</td>
<td>0.085</td>
<td>29.389</td>
<td>21.963</td>
<td>0.337</td>
<td>22.300</td>
<td>7.089</td>
</tr>
<tr>
<td>1986</td>
<td>32.636</td>
<td>8.111</td>
<td>40.747</td>
<td>28.432</td>
<td>0.444</td>
<td>28.876</td>
<td>11.871</td>
</tr>
<tr>
<td>1987</td>
<td>27.973</td>
<td>10.285</td>
<td>38.258</td>
<td>26.567</td>
<td>0.517</td>
<td>27.084</td>
<td>11.174</td>
</tr>
</tbody>
</table>

Source: Squibb Egypt's Annual Reports.

The net contribution of Squibb Egypt to import substitution increased from L.E. 4.354 million in 1984 to L.E. 11.174 million in 1987. Thus if Squibb Egypt had not been in production during this period, the government would have had to pay these amounts.

10.6 Conclusion

This chapter has focused on the effects of Squibb Egypt as a foreign subsidiary, in three respects: production and output, employment and balance of payments. Interestingly, it was found that the presence of Squibb Egypt has made a positive contribution in some vital socio-economic development areas, but it has been less than expected.

With regard to production, it can be seen that Squibb Egypt has made relatively greater progress than the industry
as a whole. However, net local value added, despite the increased supply of finished drugs on the market, was completely negative.

With regard to employment, Squibb Egypt employs a far greater proportion of highly skilled personnel, pays high wages, and employs far less labour, compared with the aggregate pharmaceutical industry. Thus, although Squibb has made a modest contribution to employment, its overall impact on the economy has been adverse, in terms of income distribution and the number of personnel, especially skilled personnel, lost to local enterprises. This has arisen because Squibb's skilled workers were already employed in local enterprises and additional investment simply resulted in a substitution of new employment at marginally higher wages for the previous employment.

Finally, a positive benefit obtained by the Egyptian economy from the subsidiary has been the reduction in imports of drugs. However, in general, it can be said that Squibb Egypt has had a detrimental effect on the balance of payments.
Chapter XI
Summary, Conclusions and Recommendations

11.1 Introduction

This study traced the development of foreign investment in Egypt since 1952, prior to examining an appropriate governmental control framework over MNEs, using Squibb Egypt as a case study.

This chapter recapitulates the key issues related to the study. The chapter consists of three sections. The first presents a summary of the analysis in previous chapters, while the second discusses the main conclusions which were drawn from the case study, and the final section presents the recommendations arising from the research findings and suggestions for further research.

11.2 Summary

There has been a tendency in recent years for developing countries to adopt a liberal economic policy as a tool for inviting multinational enterprises to operate in their country. This technique should be used to achieve certain social and economic goals of these countries and to help in economic development planning. The benefits sought from the presence of these enterprises include: increased local value added, increased employment, a favourable effect on the balance of payments and the transfer of technology.

Therefore, an effective governmental control framework for project evaluation, and monitoring of their activities is needed if the host country is to derive maximum benefit
from the presence of such enterprises.

The main aim of the present study, therefore, was to devise and test such a framework for government control of MNEs, using the case of Egypt as a developing economy and Squibb as a foreign wholly-owned subsidiary operating within that environment. In other words, the study aimed to:

1. suggest an effective control framework that could be adopted by host governments in most nations, particularly developing countries. The proposed framework is based on the accounting system of the host country, including appropriate financial and economic criteria to examine the financial and non-financial reports of the foreign enterprise concerned.

2. attempt to apply this system in Egypt, using Squibb Egypt as a case study to examine the host government control of MNEs. The major focus has been on the entry and operation control processes, using cost/benefit analysis, and other financial and administrative techniques.

To achieve the above aims, it was necessary first to examine Egypt's recent economic history, with particular reference to the influence of foreign investment, and attempts at economic planning.

Between 1952 and 1973, the Egyptian economy was planned, and attempts were made to encourage both foreign and private domestic investment. However, very little private foreign and domestic investment was made. The public sector dominated and the government became involved in finance and management to achieve social welfare.
objectives, as well as economic development. Government organisations were set up to oversee and control this development, and a uniform accounting system was enacted for planning and control purposes.

In spite of the vital progress which was made during this period, especially in the industrial and pharmaceutical sectors, the drain on resources created by the 1967 war, as well as Nasser's failure to win Western aid for such ambitious schemes as the High Dam project, created a lack of funds for investment and a consequent failure to achieve development targets. Thus, by 1973, the way was paved for a new liberal economic policy, the"Open Door Policy" by which Egypt hoped to attract foreign investment as a tool of economic development.

Based on this new economic policy, several objectives have been introduced and other policies developed. For example, the public and private sectors have been reorganised, the stock-market re-established, and the trade system and foreign exchange system modified. Another significant step was the Companies Law of 1981, which amongst other things, facilitated the formation of private companies. The overall aim of this policy is to encourage as much foreign investment as possible in order to increase GNP, reduce the balance of payments deficit, create jobs and improve social welfare. This is reflected in the issue of the Code of Foreign Investment which offers many incentives and inducements to foreign investors, including a tax

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holiday, repatriation of profits, and insurance against nationalisation or confiscation of their capital.

Despite these incentives and inducements, the policy has so far not brought about significant progress in the economy. For example, the policy has generally contributed to a growing inequality of income distribution and an imbalance of foreign investment projects between productive and unproductive sectors. It has led to price increases, and to the over-valuation of exchange rates, and has posed a threat to the uniform accounting system. It has brought about changes in consumption patterns, and has threatened the production of local enterprises and their development.

Evaluation of particular aspects of foreign investment under this policy showed that foreign investment has increased, but the gain has actually been modest in comparison with domestic investment. Production has increased, but again, not as much as expected, while the employment gain has also been modest, and focused particularly on skilled manpower.

The effect of foreign investment on the balance of payments has also been disappointing, while the incentives offered to the enterprises, and certain practices employed by the enterprises themselves, have tended to minimise the tax revenues gained by the state. Other areas such as transfer of technology and social welfare may have benefited, but these are less tangible and hard to assess.

Indeed, the absence of an appropriate control system to enable the government authorities to oversee and follow up
the actual performance of foreign enterprises may have encouraged the negative, rather than positive, impact of these enterprises. Under the investment laws, the government authorities have the right to follow-up the actual performance of MNEs, but they do not exercise these rights effectively. This is largely due to the absence of:
1. unified foreign investment laws;
2. efficient control procedures;
3. experienced staff;
4. effective evaluation measures.

This weakness provides a suitable context for the proposal of an appropriate government control framework for dealing with MNEs.

To this end, we began by formulating the structure of an appropriate framework:
1. set out in detail precisely what benefits each party will provide for the other and what their respective obligations will be;
2. set out in detail precisely what type of criteria should be adopted to measure these benefits;
3. establish the control function which should be based on accounting techniques (cost/benefit analysis, financial and non-financial measures) to reflect the targets of each side.
4. establish control procedures which will mainly be the responsibility of the government auditor and his staff, together with other departments and agencies.

At the entry stage, the host government appraises the
project's feasibility study based on cost/benefit analysis, by which the project is assessed in its technical, financial and economic aspects to ensure that only those projects which will benefit the national economy are approved.

Criteria examined at this stage include the local value added, level of employment provided, the nature and extent of any training to be provided, potential revenue to be gained from the taxes paid by the company, and the overall effect of the project on the host country's balance of payments. However, from the social point of view, several environmental and social areas should also be assessed.

Other effective control tools and policies could also be used. The first of these is the strategic policy by which foreign investors are prohibited from entering specific areas which are considered to be particularly sensitive and where the activities of MNEs could be said to pose a threat to the national interest. Local participation in ownership is a second control policy, though in practice, local participation does not always confer real control. Exchange controls may also be exercised by the host government, as well as antitrust controls.

Entry controls are of course closely related to operational control, as policies laid down at entry must be followed up by scrutiny of the actual performance of the enterprise to ensure that its operations are carried out in an approved manner.

The control process at the operation stage begins with
the requirement for disclosure of information by MNEs. It was argued that the information needs of host governments are much more extensive than those of other users, as was implicitly accepted in the United Nations Report on International Standards of Accounting and Reporting for Transnational Corporations (1979).

The second step of operational control involves financial and administrative controls. Financial controls include audit of financial statements, close monitoring of any use of fund-shifting techniques by the subsidiary, and balance of payments control, which include foreign exchange policies and tax policies to indicate the overall effect of the project on that balance of payments. Financial control of this sort covers many financial problems such as transfer pricing and also integrates with the entry control techniques applied upon the feasibility study.

The responsibility for the financial control process lies with the host government audit department, whose role in this respect is to investigate, measure and report financial information to the relevant bodies for effective correction. To this end, the government audit department should carry out not only routine compliance audit but also effectiveness and efficiency audit.

The importance of a foreign project's productivity, employment and investment to the host country create a need for administrative control. In order to achieve such control, developing countries would need to examine the non-financial reports of MNEs, including value added statements,
employment reports, etc., to reflect the extent of their contribution to the host country.

Both financial and administrative controls are an integral part of a host country's control system and they should be operated within a common framework, incorporating direct access to the accounting records of MNEs covering a wide range of areas. The shortcomings of financial statements in relation to the information needs of host governments led the author to conclude that general purpose financial statements do not satisfy the information needs of host governments, and special reports are required to provide comprehensive information. The following additional statements, therefore, were recommended:

1. A statement of value added.
2. A statement of money exchange with government.
3. An employment report.
4. A statement of transactions in foreign currency.
6. A statement of company objectives.

The third stage of the control cycle is the evaluation of the actual performance of the project and its contribution to society. This evaluation is based on more specific measurement tools such as local value added, employment, the contribution of the project to balance of payments, tax revenue gained, and the project's contribution to the economic growth of the country.
The lack of experience on the part of host developing countries regarding control processes at these stages led to the selection of Egypt as the context for the examination of this system. Squibb Egypt, which is a subsidiary of the Squibb Corporation for Pharmaceuticals was chosen as a case study to find out the effects of foreign investment on the pharmaceutical industry in particular and on the economy in general, to see what control processes are actually operated, and how they should be further developed.

Part three, therefore, was devoted to this study which was organised into four chapters. The data were collected through in-depth interviews with both the Egyptian government departments and agencies which deal with Squibb Egypt and the managers of that subsidiary. This was done by means of an open-ended questionnaire and check list administered in interviews conducted during October/February 1987/1988. The government departments and agencies were interviewed to illustrate the working of the existing controls operated by the Egyptian government on Squibb Egypt, their techniques, the effectiveness of the process and any further criteria and techniques which might be needed. Squibb Egypt’s managers were questioned to ascertain their reaction towards the governmental control system. In addition some data from laws and regulations, unpublished governmental reports and other government materials were obtained and translated from Arabic to English by the author.

It was felt that an examination of Squibb Egypt’s
development would provide important evidence in the continuing debate over the success of the open door policy and the need for an appropriate system for government control of MNEs. At this stage, it was assumed that Squibb Egypt would reveal significant progress regarding pharmaceutical production and financial performance, but it was discovered that the subsidiary has been very inefficient, with excessive production costs, relatively low employment and heavy losses and, as a consequence it has been wasteful in terms of foreign currency. With the identification of these problems, the way was paved for a more detailed investigation of the subsidiary's activities, from the feasibility study to the operating results.

In order to put the government control system into practice, law No. 43 of 1974 was enacted, creating the General Authority for Foreign Investment and Free Zones to appraise initial foreign investment proposals, approve viable ones, and follow-up their actual performance. Other departments and government agencies are involved in the process of control, each dealing with specific aspects. For example, the General Organisation of Drugs operates various kinds of control including production and pricing controls and the administration of the sector plans.

In the following three chapters (6-8), therefore, a detailed examination was made of the control exercised over Squibb Egypt by the Egyptian government.

At the entry stage (chapter 6), the feasibility study
of the project, which consisted of four parts, was investigated by the General Organisation of Drugs and General Authority for Foreign Investment, which concluded that the project was economically and financially feasible and thus recommended its acceptance. However, when the feasibility study was critically evaluated in this research according to the proposed criteria, financial analysis showed adverse results for the project, and a negative overall influence on the balance of payments, while economic analysis showed an unsound figure for value added. Some important elements of value added which were not included in the appraisal have been added to give a correct calculation of the value added indicator. This recalculation produced a result very different from that obtained in the original appraisal.

In general, it could be argued that lack of experience among the government officials involved at the entry control stage led to incorrect decision-making.

At the operational stage (chapters 7 & 8), the control process begins with disclosure of information; it was shown that differences in the accounting policies applied by Squibb Egypt and the government led to a lack of the information necessary for effective control by the General Authority for Foreign Investment, the General Organisation of Drugs, and other departments.

Financial controls (chapter 7) are applied through the monitoring of the subsidiary’s financial statements, pricing policies and taxation policy. With regard to financial
statements audit, a comparison between the planned and actual results was made in order to identify any deficiencies and to suggest appropriate remedies. A number of problems were identified, including continuing losses, foreign exchange translation, overpricing of raw materials, and transfer of funds. These problems have had an adverse effect on the Egyptian economy which the government authorities have been unable to prevent due to weaknesses in the follow-up process. It was also found that the subsidiary caused problems with the General Organisation of Drugs regarding the high prices of its drugs. Regarding the effect on tax revenue, it was also shown that the subsidiary is motivated to a considerable extent by the desire to conserve foreign currency, and to avoid taxation, leading to practices which are in conflict with the needs and objectives of the state.

At the administrative level (chapter 8), control has been more effective. The General Organisation of Drugs has, in its dealings with a large number of domestic and foreign enterprises, gained valuable experience which has enabled it to take an effective role in the subsidiary’s production planning, quality control, follow-up plans, and implementation of employment regulations. Chapter nine examined the subsidiary’s financial performance during the period 1984-1987, focusing on profitability, efficiency, liquidity and capital structure, both over the period of study, and in relation to norms for the Egyptian
pharmaceutical industry as a whole.

The result of this examination showed that Squibb Egypt's performance has been poor, when viewed in relation to that of other companies in the Egyptian pharmaceutical sector. Deficiencies identified included inefficient utilisation of assets to generate sales and profits, and a poor return on equity/operating assets.

Another problem identified has been the transfer of funds through intercompany accounts and other means, which disguise the project's true profitability and deprive the country of revenue which would otherwise have been obtained from tax etc.

These problems show a lack of effective government control, and highlight the need for an adequate control system to ensure that Egypt derives maximum benefit from the presence of Squibb Egypt in particular, and foreign enterprises in general.

The study then attempted to evaluate the impact Squibb Egypt has had on the Egyptian economy. To this end, chapter ten considered the four key areas of production, value added, employment, and effect on the balance of payments in terms of foreign exchange earnings, exports, and import substitution.

As far as production is concerned, although the subsidiary has made a relatively rapid development, its supply of finished drugs on the market was small, compared with the industry as whole. The second indicator, value
added, has been largely negative over the years in question. Examination was made of the role played by high raw materials costs and price controls on this result.

Regarding employment and wages, the subsidiary has made a reasonable contribution, especially at the skilled and semi-skilled levels, though many of these employees had in fact been employed previously elsewhere. Domestic enterprises, because of government employment policies, absorb more unemployed workers, especially at the lower end of the skills range. However, it appears that Squibb has made a worthwhile contribution in the area of the training it provides for its employees.

Balance of payments effects have been mixed. Drug imports from developed countries have been reduced, but in general, Squibb's impact has been negative, particularly as regards foreign exchange earnings. The enterprise has certainly not lived up to the expectations raised at the entry stage and more effective control will be needed if Egypt wants to attain its objectives.

11.3 Conclusions

On the basis of the study, several problems and deficiencies can be identified with regard to the government control system over foreign wholly-owned subsidiaries:

1. The Egyptian governmental control framework at all stages as currently operated over Squibb Egypt in particular and foreign enterprises in general is inadequate and must be developed further to meet national objectives.
2. It is apparent that government agencies do not fully understand the control system applied on foreign enterprises. This could be attributed to the following reasons:

   A. Lack of experience in dealing with foreign investment activities. As a consequence, they are more concerned with form than substance.

   B. The diversity of laws dealing with foreign investment, their imprecision, and differences in their interpretation.

   C. The absence of the Central Agency for Auditing in the process of control.

   D. The neglect of the Ministry of Planning in most of the process in terms of priorities for economic sectors and precise data for national economic planning, decision-making, and control.

   E. The lack of accounting techniques which threatens the appraisal of the feasibility study and the follow-up of actual performance. The significance of the role of an accounting system is to provide adequate techniques to measure the expected costs and benefits of foreign enterprises' proposals and to ensure that the actual performance is carried out in an approved manner.

3. With regard to disclosure policy, the contradiction between the accounting policies used by the government and Squibb Egypt led to a lack of the information required by
the various government departments for planning, control and performance evaluation. Therefore, the accounting systems of both sides must be co-ordinated in order to provide the government authorities with comprehensive data for accurate national planning and control of economic activities.

4. It was also found that the quality of control at all stages depends, to a great extent, on the nature of the accounting system used. However, examination of the government control process revealed that there is confusion and conflict in the application of accounting principles, rules and policies, particularly in relation to income tax and follow-up purposes. This was partly attributed to the fact that the uniform accounting system is not yet applied in foreign enterprises and partly to inefficiency in the government control system itself, which needs direct access to the accounting records of Squibb Egypt.

5. It seems that there is conflict between the objectives of Squibb Egypt and those of the country itself. Thus the study suggests a framework explaining why and how MNEs should be controlled by the Egyptian government.

6. It was seen at the entry control stage that the feasibility study of Squibb Egypt was not examined adequately by the government authorities, before it was approved. If proper evaluation had been made, it is possible that the project might not have received approval in the first place.

7. The criteria adopted for the project appraisal and follow-up are lacking in priorities and only vaguely defined.
8. The profitability of the project was measured by the accounting rate of return from the government point of view and by the payback period from Squibb’s point of view. Both were misleading since they were based on unrealistic assumptions regarding costs and revenues.

9. There was a lack of effectiveness and efficiency auditing which is of great importance for the evaluation of feasibility studies. This was due to the shortage and inexperience of staff at the General Authority for Foreign Investment. These tasks should, therefore, be carried out by the Central Agency for Auditing.

10. There was a lack of understanding of cost/benefit analysis.

11. A full guarantee on the repatriation of profits and capital to the parent company was given by the code of foreign investment. However, the government evaluators disregarded the possibility that transfer pricing may be used by Squibb Egypt to avoid exchange control, minimise taxes and custom duties, and to transfer funds.

12. Several important items of the construction costs of the project in the feasibility study were ignored. If these had been included in the feasibility study, the project might not have been approved.

13. The feasibility study did not distinguish between construction costs paid in foreign currency and those paid in domestic currency, even though one of the main objectives is that foreign enterprises should add to the reserves of
hard currency.

14. It was seen from the analysis of the costs and revenues in the first year of operation that the actual operating costs, such as direct raw materials, were excessive as compared with the feasibility study figures. This presumably resulted from the use of transfer pricing, the increase in the inflation rate, limitation of drug prices, and the devaluation of the Egyptian pound against the dollar. These factors led to losses for the project in the years concerned, and hence, affected its financial contribution to the country.

15. Overhead costs were ignored in both the estimated and actual financial statements, which led to misleading calculations of the real unit cost of drugs and unrealistic selling prices.

16. A considerable difference was found between the salaries and wages of Egyptian workers and those of foreigners.

17. With regard to local value added, it was found that the government evaluators had failed to allow for the funds which would be transferred abroad, such as royalties, fees and profits, which led to inefficient project appraisal. This is perhaps attributable to the failure of the Egyptian appraisal system to adopt the United Nations approach in this respect.

18. The criterion of employment was vague because the government did not obtain information from Squibb Egypt's management as to the minimum number of Egyptian workers to be employed and their salaries and wages rates, or the level
of skills to be considered.

19. The feasibility study showed that the position of Squibb Egypt regarding the foreign exchange criterion was satisfactory. However, assessment of its actual performance in this regard revealed that its performance was worse than expected due to many factors such as conflicting regulations, shortage of foreign currency, easy transfer of funds, and the inadequacy of the government's decision-making and control process.

20. The appraisal ignored the project's impact on the rate of growth, national planning, the environment, improvement of the infrastructure, regional development, etc. The appraisal of a project should reflect the social costs and benefits expected to be generated for the country. Failure to appraise these items could lead to an adverse impact on the socio-economic development of the host country.

21. The operational stage is the second practical stage in the governmental control process. Linking this stage with the feasibility study needs accurate objectives and appropriate financial and administrative control techniques. The importance of these techniques is to ensure that the project operations are carried out in an approved manner. Government control depends heavily on the externally audited annual reports and internal reports designed by the subsidiary's management. These reports are unlikely to be sufficient for government control purposes.

22. Several control agencies (General Authority for Foreign
Investment, Tax Administration and General Organisation of Drugs) exercise audit and financial control functions over Squibb Egypt's activities simultaneously, which may cause some confusion and create administrative problems.

23. The audit of the subsidiary's annual financial reports by the General Authority for Foreign Investment was confined to financial and compliance audit, with no attempt to apply effectiveness and efficiency audit. This is attributed to the shortage in both quality and quantity of accounting staff, to the diversity of accounting and auditing system used, and to the influence exerted by private accountants who seek to limit the power of the Authority's auditors.

24. The role of the Authority in monitoring and auditing Squibb's activities is ineffective because it carries out only some of its functions and neglects the others. Among the functions neglected we find:

A. Follow-up of the set of objectives which were previously determined in the feasibility study. Once the project is in operation, the feasibility study is cast aside as though its function was merely to aid the decision whether or not the project should be accepted.

B. Investigation of the possibility that transfer pricing techniques are being used to transfer funds to the parent company.

C. Identification of the reasons for the subsidiary's continued negative financial performance, andremedying the problems which had occurred.
D. Application of a budgetary control system in the process of accounting control over foreign subsidiaries in order to ensure that their operations are consistent with the objectives previously determined. The essence of this approach will be the comparison of the actual with proposed performance in a wide range of financial areas.

25. Accounting records and adjustments for currency translation/transactions, were found to vary between the Authority and the subsidiary, causing confusion and creating problems. For example, the Authority requires all foreign enterprises, including Squibb Egypt, to translate their financial statements as follows:

* Fixed assets must be translated using the historical rate;
* Current assets must be translated using the current rate;
* Revenue and expense accounts must be translated using the exchange rate when the elements were recognised during the period. In contrast, the subsidiary follows the "FASB" statement No. 52, which is in conformity with U.S. generally accepted accounting principles. In order to sort out this problem, it was suggested that regulation by the Central Agency for Auditing is the appropriate method in order to reflect the real value of fixed assets and depreciation and accurately reflect the reported profit.

26. Examination of the transfer pricing techniques used by Squibb Egypt revealed the abuse of these techniques, for example overpricing for pharmaceutical imports, fees,
royalties and other services offered by head office. This was mainly attributed to government failure thoroughly to investigate the internal accounting records and intercompany transactions of the subsidiary.

27. The average of overpricing for active raw materials imports for drugs was 106 per cent in 1985. It was also shown that local pharmaceutical enterprises produce drugs at much lower cost than Squibb Egypt and also sell their drugs at lower prices. The main reasons for this are that local enterprises purchase active raw materials for pharmaceuticals at lower prices under protective license, pay lower wages, and spend significantly less on sales and administration expenses. Similar cases of the abuse of transfer pricing were also found in royalties, management and patent fees. The percentage of royalties permitted to Squibb according to the foreign investment code is 7.5 per cent on net sales and the fees percentage is 10 per cent.

28. The success achieved in limiting Squibb Egypt's prices can be directly attributed to the significant role played by the General Organisation for Drugs in designing an efficient pricing policy to offer drugs at reasonable prices and consistent with world competitive prices.

29. The case study confirmed that the tax revenue obtained from Squibb Egypt since the lapse of the five-year exemption period has been zero. This could be attributed to the following reasons:

A. the poor implementation of tax investigation procedures;
B. the poor and different interpretations of tax legislations and regulations;

C. conflicts in the articles of the code of foreign investment and tax law regarding tax incentives and their applications;

D. the inexperience of staff at the Foreign Investment Tax Office;

E. the different accounting policies adopted by the subsidiary for financial disclosure to protect its earnings and avoid the payment of income tax;

F. the abuse of tax incentives by the subsidiary.

30. The administrative control process carried out over Squibb Egypt's non-financial operation aspects (production, exports, employment and planning) was more effective than the financial control process. Several specialised agencies (General Organisation for Drugs, General Companies Administration and Ministry of Manpower) are responsible for supervising these aspects. However, the dispersion of responsibility for monitoring these aspects may lead to a lack of liaison regarding the costs and benefits of the project to the country.

31. The progress achieved by Squibb Egypt regarding the increase of pharmaceutical production during the period of study can be attributed to the supervising role played by the Egyptian General Organisation for Drugs. However, it should be noted that its production is still very heavily
dependent on the import of basic raw materials from the parent company at high prices, which has affected the profitability of the company and the level of drug prices in the local market.

32. One of the main objectives underlying the acceptance of Squibb Egypt was to export a large volume of finished drugs. However, the Arab boycott and other local factors have led to poor export performance.

33. It was found that the process of control over Squibb Egypt's employment was in general undertaken in an effective manner by the departments responsible. However, because the employment criteria were vague, the subsidiary was not asked how many jobs it would provide for Egyptians each year and in each category, or what training would be provided. In addition, there was a lack of follow-up employment reports which should have been submitted quarterly to these departments for variance analysis. Moreover, the lack of exchange of employment reports among the General Companies Administration, General Authority for Foreign Investment and the General Organisation of Drugs created confusion.

34. It was found that the General Organisation for Drugs has played an effective role in overseeing Squibb Egypt's planning system, which is designed to follow certain rules, procedures and forms imposed by various agencies according to national policy for the pharmaceutical industry. However, direct and indirect links between the Ministry of Planning (national development plans) and the subsidiary's budgets and investment programmes are totally ignored. In addition,
there is a lack of follow-up reports which would help these departments, including the Ministry of Planning to trace the reasons for production variances in order to take any necessary corrective actions.

35. Performance evaluation of the subsidiary is carried out by the General Authority for Foreign Investment whose staff lack experience in this respect. Moreover, the actual performance of the subsidiary is measured by inadequate economic and financial indicators such as gross value added/investment cost ratio, gross value added/total sales ratio and net profits/net local value added ratio.

36. In evaluating the actual performance of the subsidiary, it was found that:

A. The financial performance of Squibb Egypt is poor and the progress achieved so far is negligible. For example, the subsidiary’s profitability has been consistently negative during the period of the study.

B. The subsidiary’s long-term loans are obtained from local banks in both local and foreign currency.

C. The amount of debts are more than three times the level of self-investment in the period 1984-1987, showing a high negative return on net operating assets and equity, due largely to the amount of interest and foreign currency charged to financial statements.

D. The financial gearing of the subsidiary appears to have been unbalanced.

E. The subsidiary has achieved a high rate of
growth in production in the period under examination, but the net value added is negative.

F. The subsidiary employed a small size of labour force as compared with other foreign and domestic enterprises. However, there is an indication that the number of the labour force will increase in the future because the subsidiary is keen to extend its size and production capacity.

G. Squibb Egypt's training policy has been concentrated on two types of training for its labour force, either within the subsidiary or abroad: a basic training programme for all skilled and semi-skilled workers and some supervisors, foremen and technicians covering technical and professional training, job instruction and safety; and technical training for a selected number of managers, supervisors and foremen. This programme has aimed to develop labour force skills in order to allow them to absorb the type of modern technology applied at the subsidiary, and to acquire more technical information about modern methods of production in the pharmaceutical industry.

H. Wages and salaries per employee paid by Squibb Egypt are substantially higher than those paid by national enterprises and other foreign enterprise.

I. Squibb Egypt has attracted skilled and semi-skilled workers away from domestic enterprises as a result of its high wages. This has led to a negative impact on the productivity and performance of national
enterprises and even posed a threat to the production of these enterprises. Moreover, there have been other side effects such as increased local price levels, inequality of income distribution, and so on.

J. As far as the balance of payments is concerned, no significant benefits have been derived from the presence of Squibb Egypt. Its contribution to exports has been remarkably low as a result of several internal and external factors. Indeed, it has reduced the amount of foreign currency earned by the country. However, import-substitution was a significant factor, for the absence of Squibb Egypt as producer of drugs would have resulted in the import of more foreign produced drugs with more foreign currency expenditure.

From the above analysis it may be concluded that Squibb Egypt has made only a modest contribution to the economy. This deficiency is attributed to several factors, among them the absence of adequate accounting control techniques, comprehensive audit, sound information system for performance evaluation, and of an appropriate government control structure, and the existence of imprecise and ill-defined criteria adopted to meet the government objectives. In addition, there has been lack of co-ordination and poor communication between various government departments and the Ministry of Planning.

All in all, it seems that the government control system
in Egypt is weak and its objectives are not closely linked to the overall national planning system.

11.4 Recommendations

The above conclusions have provided a strong case for arguing that the adoption of a sound government control system is essential to alleviate many of the problems and deficiencies raised in this study. The emphasis is on the need for special purpose reports and for a government auditor who will be responsible for implementing this system in an appropriate manner. Reliance upon a control system of this sort has very important implications not only for Egypt, but also for other developing countries.

Thus, in the creation of such a control system, the following suggestions and guidelines are likely to be essential. The main purpose of this system is to sort out the problems and deficiencies caused by the system currently operated, improving the foreign investment climate and the co-ordination between control stages and various government departments within the national planning framework:

1. Effective government control should be carried out in the most efficient manner by means of direct access to the accounts and budgets reports of the foreign enterprise.

2. The framework should have the following general characteristics:

A. A clear specification and co-ordination of the country's socio-economic objectives.
B. Integrated and relevant structure of government bodies responsible for the control process.
C. Relevant accounting and auditing systems.
D. A closer connection between entry and operational controls and performance evaluation.
E. A relevant feedback system.

3. The new control system should be based on the local accounting and auditing system which in turn would truly reflect the local needs and circumstances. In order to achieve this task, the uniform accounting system and government auditing standards require to be developed and expanded for utilisation in foreign enterprises in order to achieve the specific objectives of the country and provide the information needed for planning and control.

4. The criteria required for this system should also be clearly specified and laid out in accordance with their priorities so as to meet national objectives and those of the foreign enterprises.

5. The responsibility for the control and audit functions should be based on the Central Agency for Auditing, which has the power to carry out comprehensive audit and control techniques. To facilitate this task, the government should reorganise the department and rearrange training system for its staff, improve the code of foreign investment and ensure effective co-ordination with the other departments responsible including the Ministry of Planning and General Authority for Foreign Investment.

6. Information disclosure for governmental control purposes
should draw heavily on the special reports which were suggested in the UN Report on International Standards of Accounting and Reporting for Transnational Corporations in 1979.

7. In general, the functions of the General Authority for Foreign Investment should be to prepare a list of the activities for which foreign capital is invited, encourage MNEs by advertising the objectives of the ODP, incentives offered and the opportunities available. In addition, it should co-ordinate with the Ministry of Planning to keep accurate data about the national plan objectives and the priorities of sub-plans. Moreover, it should compile and classify the feasibility studies of potential projects and send them to the various government departments involved including the Central Agency for Auditing, for study and investigation, and receive the final decision on the project proposal which will subsequently be sent to the investor.

8. At the entry control stage the following steps should be given serious consideration:

A. The investigation of a project's feasibility study should be based on social cost/benefit analysis which would provide a significant framework for examining the contribution of any proposed project towards the achievement of the country's objectives.

B. To do this, the government should adopt net social present value as an appropriate criterion for accepting a project and measuring its potential
financial contribution to the national economy. This should be associated with the shadow discount rate and social prices.

C. With regard to the economic evaluation of the proposed project, value added provides an appropriate criterion. With this approach, the government should consider profit remittance, royalties, fees and interest as cost items when they calculate the net local value added to the national economy.

D. Another criterion is the level of employment provided. In this regard, the government could judge the project by identifying the minimum number of Egyptians the project should employ and the new skills to be offered. Accordingly, the government should bring this criterion within its operational goal and set up standards; at the end of each period, a comparison between the actual performance and that estimated in the feasibility study should be made, together with a comparison between this project and other enterprises in the same industry.

E. The effect of the investment project upon the balance of payments of a host country should be measured by Sanjaya and Streeten's equation.

F. The government must rank the above criteria according to their relative importance to the national objectives and use them to decide upon the acceptability of the proposed project. The relative
importance of these objectives will differ from one sector to another and may change over time.

G. The possibility of abuse of transfer pricing techniques by the entry MNE must be checked, and the use of arm's length prices would solve this problem.

H. The demand for financial and non-financial information on a proposed project is of paramount importance to allow the Central Agency for Auditing to appraise the project, identifying its impact and its costs and benefits for the economy as whole.

I. Audit should be carried out by the agency's staff. Therefore, the staff of this agency should include various specialists such as accountants, auditors, civil and mechanical engineers, operational researchers, surveyors, lawyers, economists, quantity surveyors and architects, statisticians, pharmacists and doctors, etc. The comprehensive assessment of the financial and non-financial information contained in the proposed project reports should be investigated by the government auditor, especially in the fields of engineering and technology, economics and accountancy, finance, etc.

J. The above comprehensive investigation should be in terms of value for money audit and efficiency audit rather than financial and compliance audit. The adoption of a more comprehensive investigation like this may create a need for more legal power to enforce the government auditor's authority over the audit of
private sector activities.

K. The investigation processes should be co-ordinated and linked with other responsible departments including the Ministry of Planning wherever possible.

L. To bring this about, it is of paramount importance that a unit be established within the agency to be responsible for receiving, studying, evaluating, and making recommendations on foreign proposals which come within their sphere of economic activity. By doing so, the following advantages can be achieved:

i. This unit will have the expertise that will not be available to the General Authority for Foreign Investment and other government departments.

ii. It will use accurate and reliable accounting techniques for measurements and reporting.

iii. Project proposals will be evaluated in relation to the priorities of the national development plan and sub-ministries' plans, and will comply with the rules of the Code of Foreign Investment.

iv. There will be a saving in the time and cost of sending proposals for the approval of the technical departments and ministries.

v. The co-ordination and communication between the agency and other departments will be greater than at present in the Authority.

vi. The technical, economic, financial, social and managerial aspects will be assessed at the same time by
a variety of specialists in different fields of project appraisal.

vii. The feasibility study which measures whether or not the project is socially beneficial will be kept by this unit to facilitate the task of the auditor in controlling the approved project at its operation stage.

viii. The project management will know which agency to deal with.

ix. After project proposals are assessed by this unit, final approval will be sent to the Authority which will in turn send it to the potential investors.

x. Following-up and comparing the actual results of the project activities at its operating stage will be a main function of this unit together with the Ministry of Planning and technical ministries.

In addition to the steps mentioned above, the proposed system will help to eliminate the conflict between the Authority and technical departments which occur under the current system. Also it will eliminate the complaints of the Authority of shortages of trained staff and will give it more time to devote its efforts towards attracting the required foreign enterprises and modify foreign investment policy.

9. At the operational control stage, the process of control should be classified into three subsequent categories: financial control, administrative control and performance
evaluation.

10. With regard to financial control, a number of steps are required to improve the process:

A. It is essential for the feasibility study to be kept by the bodies responsible for monitoring and following-up. In addition, its objectives should be clearly defined within the national planning framework. This in turn facilitates the efficient operation of the financial control process.

B. The foreign enterprises must prepare and send their quarterly and annual budgets to the government departments involved in accordance with the requirements of the local accounting system. This in turn will allow the government to demand relevant financial information for controlling the economic performance of these enterprises.

C. The financial information needed by the government authorities to enable them to monitor the enterprise's performance, should be disclosed at the year-end, based on local accounting policies.

D. Non-financial information is also necessary to allow government authorities to judge the enterprise's contribution to the country's economy.

E. The responsibility for the financial control process in relation to the enterprise's performance should lie with the Central Agency for Auditing, which
will ensure that the MNE adheres to the terms of the concession agreement and the requirements of the Tax Administration for income tax purpose. Monitoring of the activities of foreign enterprises by private external auditors does not satisfy these needs.

F. The essential function of the Central Agency for Auditing will be the application of value for money audit, together with financial and compliance audit to ensure, not only that the foreign enterprise utilises its resources in an economical and efficient manner, but also that government objectives are achieved. This investigation of the activities of MNEs can be summarised as follows:

i. audit carefully the internal control and auditing system to ensure that these systems are adequate, effective and based upon proper documentary evidence;

ii. examine the records of the enterprise's budgets and the actual results of their implementations;

iii. compare the actual performance against these budgets, comparing those results also with historical data (i.e. prior periods' financial reports), and with data for other similar enterprises in the same sector and over the same period;

iv. use ratios to help to monitor the enterprise's performance.

v. investigate the foreign exchange translation policy to reflect its overall effect on government revenue and its conflict with local policy. The Egyptian standard
for foreign exchange should be applied to these enterprises as a proposed solution to the translations problem.

vi. As it was evident that Squibb Egypt and other foreign enterprises have abused transfer pricing techniques, the Central Agency for Auditing (CAA) should keep this in mind and carefully investigate this phenomenon as follows:

a. Ask management to make clear in their reports the percentage of raw materials and intermediate goods imported, classified according to the source, volume and quality of each item and its price. Prices and quality should be carefully examined in relation to prices and quality in the international market, and information should be obtained from other sources for comparison.

b. Ask management to indicate in their reports, the amount and percentage of profits, royalties, management fees, patent fees, to sales. In this context, the CAA should ensure that these items are examined and compared with the terms of the concession agreement.

c. The CAA and Central Bank should also carefully investigate the financial structure of these enterprises and the documents of intercompany payables and receivables, local borrowing and interest rates, and liquidity and availability of funds to ensure that
the repayment of debts and their interests have been systematically paid.

d. Co-ordination between the CAA and other government departments such as Tax Administration, customs authorities and the Central Bank should be strengthened in order to control and detect any abuse of transfer pricing.

vii. In addition to its responsibility for monitoring financial information the CAA is required to audit all non-financial information, for example, following up production, employment, exports etc. In this context, the CAA is given the right to monitor and control the implementation of investment projects within the framework of plan with regard to investments, production, exports, employment, etc.

viii. Finally, after examining the information given above, the CAA is required to write a report to the People’s Assembly, the supervision department and Tax Administration, drawing attention to significant features of the enterprise’s performance and its financial status, explaining the main reasons for any inadequate performance and making proposals for remedies.

9. With regard to the tax system, several changes should be made, as follows:

A. The government should set up more realistic tax incentives because those operating at present are of low value to both MNEs and government. The aim of
the tax policy is to solve the balance of payments problems and increase the country’s income. Generally, the tax system should be consistent with the broadly-based socio-economic development plans of the country.

B. The implementation of tax legislation should be improved over a broad spectrum in order to help achieve control over foreign enterprises' activities and measure their annual net income for tax purposes, minimise the possibility of tax evasion and indicate the impact of transfer pricing and fluctuations in foreign exchange rates.

C. Simplification of the tax investigation procedures is also necessary for improved application of tax law and effective performance of the tax office in collecting tax.

D. Co-ordination between the tax office and different government departments (i.e. CAA, supervision ministries, etc.) is necessary in order to control any tax evasions. Therefore, the Tax Administration should have more authority and responsibilities.

F. The Tax Administration must be provided with skilled staff to deal with the investigation of MNEs for tax purposes.

11. Regarding the administrative control process, it is believed that this system should be further development, while the supervision departments are recommended to
continue with it, with the proviso that co-ordination among
the CAA, Planning Ministry and supervision departments
should be regularly provided in order to achieve effective
control over the non-financial reports of MNEs.

12. Based on such patterns, the set of performance criteria
presented in the United Nations study on Transnational
Corporations should be adopted to compare actual
performance. These criteria, once decided upon, should be
kept stable as long as possible. If any deficiency is found
in relation to any criterion, the necessary change should be
undertaken in the light of its impact on the foreign
investment policy and MNEs in operations. If the government
does not give attention to this recommendation, the
establishment of an entry control process will be of no
meaning.

While the above discussion was related to the Egyptian
government control over MNEs operating in Egypt, much is
also relevant to all developing countries. The results of
this research are useful in that they provide a particular
host government with an effective control framework based on
its own accounting system, to enable it to follow-up and
measure the effects of MNEs on the national economy. Also,
the results will be useful if the government is going to
decide whether to apply uniform control techniques and
measures to all MNEs or whether such techniques and measures
should differ from one enterprise to another depending upon
the economic sector in which it operates.

All in all, an effective framework for governmental
control over MNEs in Egypt is needed, and steps towards establishing such a framework should be undertaken immediately. This framework should be based on the local accounting system, and the responsibility of the control process will lie with the government auditor rather than other government departments. Another relevant point is that control of this sort is totally outside the traditional reporting and auditing framework. Admittedly, at this stage the proposed framework will encounter some difficulties in its application, but these should be no greater than those occurring in the present system.

11.5 Suggestions for Further Research

The present study examined the controls exercised over MNEs by the Egyptian government, with particular reference to the pharmaceutical sector, using Squibb Egypt as a case study. Research should now be extended to evaluate the economic and financial impact of, and controls over, MNEs in other sectors and other countries.

In the Egyptian context, a number of studies could be conducted focusing on MNEs operating in various other sectors. Particular attention should again be given to the role of the government auditor and accounting problems such as transfer pricing, foreign currency translation, etc., and to their effects on the sector concerned and hence the economy as a whole. It may be that different sectors present different control problems; moreover, because differing roles may be accorded to the various economic sectors,
expectations and needs from MNEs in these sectors may also vary.

Research in this area could provide a more complete picture of the impact of MNEs throughout the Egyptian economy, and may enable the government to assess the effectiveness of its control mechanisms across a broader spectrum. This in turn will help the authorities decide whether uniform controls for all sectors are appropriate, or whether there is a need for some measures specific to a particular industry or sector. Control effectiveness could then be improved across the whole economy, to maximise the benefit to the country of MNE activity.

As the controls actually used may vary from one country to another, and the most appropriate focus of control may be country-specific, there is a need for research to examine the controls used by other countries, and to identify those needed in other environments. The control model adopted for the present study could be applied in the context of other host developing nations, and if necessary, revised to suit their objectives and environments. Thus, governments in various countries can be acquainted with the control experiences of others, helping them to devise the most effective framework for their own needs with a view to ensuring that the benefits expected from foreign investment are actually realised.
APPENDICES
Appendix - 1

CHECK LIST

(SQUIBB EGYPT)

(1) General Information

Historical Background
- nationality
- location
- nature of the activities
- the structure of ownership and control
- the main objective of the enterprise

Production Information
- product design
- production capacity
- production policy
- product unit
- production techniques
- types and number of product
- quality control system

Financial Structure
- source of finance
- cost of capital
- total of self finance
- total of debts
- total of fixed assets
- total of working capital

Internal Control System
- accounting policies
- reporting system
- internal and external auditing system
- administrative control system

How the Enterprise Run
- the structure of enterprise's organisation
- number of directors on board
- the degree of communication and coordination within the subsidiary
- the degree of relationship with the Head Office's management

Government Control Techniques at Entry and Operation
- cost/benefit analysis
- financial control
- administrative control
- legal and economic policies
- performance measurements

**Egyptian Government and the Enterprise Objectives**

<table>
<thead>
<tr>
<th>Government Objectives</th>
<th>Enterprise Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>- increase the national production</td>
<td>- profit maximisation</td>
</tr>
<tr>
<td>- the project should add to the national income</td>
<td>- worldwide growth</td>
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<tr>
<td>- creation of new jobs</td>
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<tr>
<td>- export orientation</td>
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<tr>
<td>- import substitution</td>
<td></td>
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<tr>
<td>- foreign currency earning</td>
<td></td>
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<tr>
<td>- transfer a high standard of technology</td>
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<tr>
<td>- increase the level of government revenue</td>
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</tbody>
</table>

**Inducements and Incentives**

- depreciation allowance
- tax holiday
- guaranteed repatriation of profits and capital
- subsidies protection
- duty or tax remission
- providing the required infrastructure
- insurance against the nationalisation or confiscation of capital

**Protection policies**

- import tariffs policy
- priority policy
- competition policy
- disclosure policy
- foreign exchange policy

(2) **Entry Control System**

A. Data required in the feasibility study:

(i) Data about the construction stage, including the initial investment costs and inputs required for construction, sources of material inputs, area of land needed, the amount of assets needed, quantity and quality of labour, and the time required for construction.

(ii) Data about the expected operating stage, including types of products to be produced, proposed rate of production output quarterly or annually, expected selling prices, proposed rate of exports, proposed sources of raw material and intermediate products inputs, the project volume, prices and types of
materials, the expected number of labour force to be employed (types, sources and skills) and their expected wages, and the amount and the types of assets and power to be used.

(iii) the initial financial position, including total fixed assets and working capital, expected source of finance, currency used in the initial finance and interest rates and repayment of borrowed capital.

(iv) the method used to measure the profitability of the proposed project.

(v) the expected amount of profit and capital to be remitted to parent company.

(vi) the expected domestic sales of drugs product (volume and prices) and the size of exports and their expected value.

(vii) the expected percentage of export/sales

B. The body responsible for preparing the feasibility study.

C. The Egyptian government departments involved in monitoring and investigating the feasibility study.

D. The procedures of studying and investigating the feasibility study.

E. The period taken to reach a decision on investment proposal.

F. The set of financial and economic criteria determined for feasibility study evaluation and investigation.

<table>
<thead>
<tr>
<th>Economic</th>
<th>Financial</th>
</tr>
</thead>
<tbody>
<tr>
<td>value added</td>
<td>pay back period</td>
</tr>
<tr>
<td>employment</td>
<td>accounting rate of return</td>
</tr>
<tr>
<td>balance of payments impact</td>
<td>internal rate of return</td>
</tr>
<tr>
<td>rate of growth</td>
<td>net present value</td>
</tr>
</tbody>
</table>

G. The accounting techniques and policies used by the government to examine the project's feasibility study.

H. The results of negotiation on conflicts arising during
the evaluation at entry time in terms of:

- disclosure policy.
- the rate of profit and capital annually should be remitted.
- foreign exchange rates.
- accounting policies used.
- the possibility that transfer pricing may be used to avoid exchange control and minimise taxes.

(3) Operational Control System

A. Information required for the control process at operation stage and evaluation of the actual performance of the enterprise. This includes financial and non-financial information.

(i) Financial information:

Types of financial statements required are:

1. Financial Position statement (Balance Sheet) includes:

   a. total assets

      (i) fixed assets
      - long-term assets
      - short-term assets

      (ii) current assets

   b. liabilities and Head Office Account
      - long-term liabilities
      - current liabilities
      - Head Office Account

      (iii) Balance sheet notes
      - depreciation methods for asset items
      - inventories policies
      - the foreign currency used for translation
      - the interest rate related to long and short-term loans
      - information about working capital
      - financial ratios related to balance sheet items

2. Income Statement, including

   - the total sales (1983-1987)
   - the total costs of drugs sold each year (1983-1987) either in the Egyptian market or exported to international markets or transferred to parent company or other sister subsidiaries
   - the total cost of raw material imported and locally purchased
- the total cost of salaries and wages either foreign or Egyptian workers
- the total marketing and administrative expenses (1983-1987)
- the total amount of depreciation, interest, foreign exchange differences
- the gross profit before tax and net income
- the amount of profits remitted abroad annually and its percentage to total profit
- the amount of funds repatriated to the head office in terms of fees, royalties and other funds.

a. **Income statement notes**

- the accounting methods and policies for measuring the annual profit
- the profitability ratios used
- accounting policy for preparing periodic reports
- accounting policy for foreign exchange transactions /translation (gains and losses)
- transfer pricing policy
- a description of the transactions related to revenues and expenses either with group enterprises or parties outside the group.

b. **Other information related to income statement**

- the percentage of total sales to the pharmaceutical industry's total product
- the percentage of total cost of production to the other local and foreign enterprises' cost of production
- the percentage of exports to industry's total export
- financial ratios compared with other local and foreign enterprises.

3. **The funds flow statement**

   (i) **Sources of funds**

   - data about new capital introduced each year by Head Office
   - data related to the amount of loans granted
   - operating income after adjustment for non-cash expenses
   - sales of assets or investments
   - depreciation
   - deferred income tax
   - undistributed earnings.

(ii) **Use of funds**

   - increase in working capital (inventory and debtors)
   - amount of withdrawals of capital by Head Office
   - repayments of loans
   - operating losses
- purchase of assets or investment
- dividends.

4. **Cash flow statement**, including
   - cash receipts from sales and debtors over a period of time
   - purchases of goods and payments to creditors
   - payment of wages and salaries
   - payment of interest
   - capital expenditure on extension of laboratories or other investment.

Additionally, it should be noted that the amount of funds provided by grants, if any, from the government as a subsidy is required for the research.

**Users of Financial Statements:**
- tax authorities
- Subsidiary’ management
- Head Office
- The General Companies Administration
- The General Organisation for Drugs - The General Authority for Foreign Investment - The Central Agency for Auditing

(ii) **Non - Financial Information**

This represents the provision of information disclosed by the enterprise in addition to the financial statements. The non-financial reporting includes information related to specific purposes such as employment, production, investment and programmes, trading, value added report and statements about future prospects. This is likely to be useful to Egyptian government officials for evaluation purposes.

1. **Employment report includes:**
   - number and details of employees both in total and segmented by line of production (1983-1987)
   - the level of labour force skills
   - labour turnover
   - labour force cost (including social expenditure and costs of training)
   - data about the training courses
   - data about annual employment (number of workers and their wages and salaries) of the local and foreign enterprises in the same pharmaceutical sector.

2. **Production report comprises:**
- the types of drugs product produced
- item code number
- dosage form
- the size of drug product monthly/quarterly and its value (direct and indirect costs)
- the size of local sales and exports monthly and their value
- the size of drugs stock monthly/quarterly and its costs
- the average capacity monthly/quarterly utilisation
- source of raw materials
- methods and processes of drugs production
- intermediate product transferred from and to other sister subsidiaries
- additional information about the other enterprises regarding their annual drugs product.

3. Trading information consists of two parts:

A. Imports reports refer to:
- total volume of importation monthly/quarterly or annually
- type and name of each active raw material or intermediate product imported
- price of each item (FOB)
- quality specification
- name of exporter
- country of exportation
- country of initial origin of product
- import tariffs and duties
- import permits and prior deposits if any.

B. Exports report includes:
- total volume of drugs exported
- type and name of each item of drug exported
- price of each item exported (CIF)
- quality specification
- export procedures
- total cost of drug products exported
- name of importer, country of importation.

4. Investment Programmes
- new capital expenditure
- new laboratories
- development in production
- others

5. Organisational Structure
- a description of the subsidiary's management structure
- a description of the communication between the subsidiary's directors and Head office on the one
hand and the Egyptian government officials on the other.

6. **Value Added Statement**
- data on output of the subsidiary and other local and foreign pharmaceutical enterprises
- data on raw materials and intermediate products
- data on depreciation
- data on profits, fees, royalties and other services
- data on interest on loans
- data on tax
- data on wages and salaries and other benefits.

**Users of non-financial reporting:**
- Head Office
- Subsidiary management
- The General Organisation for Drugs
- The General Authority for Foreign Investment
- The General Companies Administration
- The Ministry of Planning
- Others

B. **The subsidiary’s accounting policies**
- disclosure policy
- preparation of financial statements based on:
  - historical cost
  - current cost
  - inventory policy
  - depreciation policy
  - foreign exchange translation policy
  - others

C. **The Control Techniques adopted by The Egyptian Government:**

1. **Financial Control** which includes,
   - external audit of the subsidiary’s financial statements in terms of:
     a. financial and compliance audit
     b. value for money audit and efficiency audit
       - budgetary control
       - balance of payment policies in terms of:
         a. foreign exchange policies
         b. tax policy

2. **administrative Control**
   - production control
- employment control
- planning system
- quality control
- others

D. The governmental control structure involved
- Tax authorities
- General Companies Administration
- General Authority for Foreign Investment
- Ministry of Planning - Central Agency for Auditing
- General Organisation for Drugs
- others

E. Criteria for control process
- profit measurements - value added - employment
- foreign exchange earning
- others

F. The techniques of performance evaluation in terms of the set of criteria previously determined.
- the contribution to level of national output
- the contribution to the level of employment
- the contribution to the level of balance of payments
- the contribution to the level of government revenue
- the contribution to long-term rate of growth

G. Other observations
Appendix - 2

Questionnaire

Government Officials

A. General Information

A1: Would it be possible for you to supply information regarding foreign enterprises in general and Squibb Egypt in particular at present in relation to:

1. The legal form
2. The geographical areas where operations are carried out
3. The main characteristics
4. The main activities
5. The form of ownership and the percentage of local participation
6. The form of capital

A2: In the context of the foreign investment Law 43 of 1974 and its Amendments, what sort of policies, regulate Squibb Egypt in particular and MNEs in general?

1. Ownership policy
2. Taxation policy
3. Foreign exchange
4. Tariffs policy
5. Competition policy
6. Pricing control
7. Others. Please comment.

A3: If the Foreign Investment Law has no proper policies, are there any special appropriate regulating policies?

Yes ___ No ___ If yes, please specify.

A4: What are the best means of regulating MNE's investment?

1. A general legislative system
2. A hybrid system - (general legislation and individually negotiated agreements)
3. Individually negotiated agreements.

A5: Why do some MNE's like Squibb Egypt use the wholly-owned subsidiary form?

A6: Do you consider that Squibb Egypt in particular has
contributes positively to the Egyptian economic development?

Yes ___ No ___

A7: If the contribution is positive, indicate what contribution you consider has been made in the areas of

1. Creation of new jobs and training;
2. Utilisation of local raw materials;
3. Creation of competitive markets;
4. Transfer technology;
5. Raising the level of exports;
6. Import substitution;
7. Increase of the gross national product;
8. Increase in the level of government revenue;
9. The balance of payments;
10. Other factors. (Please comment)

A8: What, in your opinion, is their relative significance?

A9: In the case of a negative contribution, indicate the main negative effects brought about by Squibb Egypt regarding:

1. Job creation;
2. Adaptability to local environment;
3. Threat to local markets;
4. National output;
5. Impact on the balance of payments;
6. Other factors. (Please comment)

A10: Could you evaluate the relative impact of these negative contributions?

A11: Does the Egyptian Government exercise active control over foreign enterprises (within the national boundaries)?

Yes ___ No ___

A12: If affirmative, could you specify the form of Government control over MNE subsidiaries at the entry stage and during operation?

___ Cost / Benefit Analysis
___ Financial control

461
Administrative control
Economic control
Legal control

Please comment.

A13: Was there use of any particular methods for the control process?
1. Rules and decrees from legislation.
2. Economic and social policies.
3. Accounting techniques and reporting.
4. Other methods.

A14: What type of information do you usually require from MNE’s for the attainment of those techniques?
   a. Information relating to financial areas of the subsidiary
   b. Information relating to non-financial areas.
   c. Other

A15: To what extent does the information acquired from the enterprise satisfy your requirements for effective control?

A16: What rules are necessary to ensure that foreign enterprises provide the necessary information in an easily accessible fashion?
   Agreement rules
   National foreign investment Law
   Disclosure policy of status
   Others

A17: Where does the responsibility for the execution of control lie?
1. The General Authority for Foreign Investment
2. The Ministry of Planning
3. The Central Agency for Auditing
4. The Supervising Ministry
5. Combination of interested bodies
6. Others. Please specify.

A18: Has there been/is there overall coordination between departments in charge of control?
A19: If yes, to what extent does coordination ensure effective control over Squibb Egypt?

A20: How, and how often is there contact between the controlling bodies and the management of the subsidiary?

1. Personal contacts - Frequently
2. Periodic reports supplied by the subsidiary, Quarterly/Annually
3. Other. Please specify.

B. Government control over MNE's at entry time

B1: What have been the main objectives of the Egyptian Government during the last national five year plan regarding foreign enterprises in relation to:

1. Employment creation
2. Export - orientation and import - substitution
3. Increasing the growth of gross national product
4. Easing the difficulties in the balance of payments
5. Others. Please comment.

B2: Should a feasibility study be required by Egyptian foreign investment laws for a foreign enterprise proposal?

Yes ___ No ___

B3: If affirmative, should this feasibility study be made subject to audit?

Yes ___ No ___

B4: Where should the responsibility for the carrying out of this audit lie?

1. Foreign enterprise's internal auditor
2. A private external auditor
3. The Central Agency for Auditing
4. The General Authority for Foreign Investment Board
5. A special group of experts
6. Others. Please comment.
B5: If the answer to B3 is No, how are the decisions of a new foreign enterprise regarding investment plans and feasibility studies to be monitored by Government bodies?

a. Formal concession agreements
b. By virtue of Egyptian foreign investment laws and regulations
c. By negotiation
d. Others. Please comment.

B6: What are the data required in the feasibility study of a new foreign enterprise at the entry stage?

- Initial investment costs
- Source of raw materials
- Quantity and quality of labour force and their wages and salaries
- Type of production to be produced
- Methods of production and equipment used
- Source of finance
- Currency used in finance
- Proposed rate of output
- Pricing policy
- Proposed rate of return
- Other data

B7: What set of criteria, in your opinion, should be used to determine whether or not a new foreign enterprise’s proposal is adequate to the country?

a. **Economic Criteria**
   - Value added
   - Level of employment provided
   - Balance of payments impact
   - The contribution to long term rate of growth.

b. **Financial Criteria**
   - Net present Value
Pay Back Period

Accounting rate of return or Internal rate of return

B8: Would it be possible for you to evaluate the relative significance of these criteria?

B9: What is the process of approving a new foreign enterprise investment proposal by Government bodies?

- Examining the availability of the enterprise in the Egyptian environment
- Examining the technical aspects of enterprise
- Examining the financial and economic aspects
- Examining the consistency of its investment plan with national economic development plans
- Ensuring that its policies are consistent with Egyptian foreign investment Laws and regulations.

B10: Who has the responsibility to examine and approve a new foreign enterprise proposal?

1. The General Authority for Foreign Investment Board
2. The Central Agency for Auditing
3. The Ministry of Planning
4. The supervising Ministry
5. A special group of experts
6. Others. Please comment.

B11: Was/is there any formalised costs/benefits analysis technique to examine the new foreign enterprise proposal?

Yes ___ No ___

B12: If the answer is yes, who is in charge of this formalisation and application?

a. The General Authority for Foreign Investment
b. The Ministry of Planning
c. The Central Agency for Auditing
d. The supervising Ministry
e. The parent company
f. The foreign enterprise subsidiary internal manager/auditor
g. Private external auditor
h. Others. Please comment.
B13: To what extent would the costs and benefits, associated with MNE's investment be different if there were no MNE's?

B14: Should a foreign enterprise determine its investment plans and feasibility study consistent with national five year plan objectives?

Yes ___  No ___

B15: If the answer if Yes:
- What steps should be taken by the Government to ensure that the agreement is in line with national objectives?

- What right of access is the government to be given to acquire information for this purpose?

B16: In your opinion, would there be major conflicts between the foreign enterprises and the Egyptian Government on the negotiation table at entry time under the concession agreement?

Yes ___  No ___

B17: If Yes, what are the major sources of conflict you expect to arise?

a. The rate of profit and capital transferred abroad
b. Foreign exchange rates
c. Transfer pricing
d. Ownership and control
e. Information disclosure
f. Others. Please specify and give comments.

C. Government control at operation stage

C1: Should Egyptian Government departments carry out the control process over foreign enterprises activities to measure actual performance against the criteria adopted and policies determined at entry time ?

Yes ___  No ___

C2: If the answer is Yes, what are the types of information
needed about their activities?

(a) **Financial**
- Income statement, including operating results and sales
- Balance sheet
- Change in the financial position statements
- Other information regarding transfer pricing policies and foreign exchange.

(b) **Non-Financial**
- Employment
- Value added
- Investment plans
- Production
- Trading
- Others

C3: What is the most suitable accounting system to allow the collection and use of these information in an efficient and integrated fashion?

___ Egyptian uniform accounting system
___ Parent company accounting system
___ Home country system
___ International accounting standard
___ Others. Please specify.

C4: What type of reporting requirement should be established to provide this information for Government departments in an efficient manner?

1. Financial reports  a. Quarterly  b. Annual
2. Social reports
3. Non-financial reports
4. Others.

C5: To whom should these reports be made?

1. The General Authority for Foreign Investment
2. The Central Agency for Auditing
3. The Ministry of Planning
4. The supervising Ministry
5. External auditor
6. Others. Please specify.
C6: What are the different purposes which these reporting systems serve?

1. Taxes
2. Planning and control
3. Performance evaluation
4. Others.

C7: What measurement criteria are used for the control process to gain information about the net profitability of operations of foreign enterprises in accordance with local accounting practice? By what processes can the criteria be applied?

1. The local value added
2. Employment output
3. Export/import ratio
4. Net present value of cash flow
5. The rate of growth
6. Other comments.

C8: What is the role of the Central Agency for Auditing in the audit of foreign enterprise reports?

a. Financial Reports
   - income statement
   - balance sheet
   - funds statements

b. Non-Financial and Social Reports
   - employment report
   - value added report
   - trading report in volume form
   - production report
   - investment plans reports
   - organizational structure
   - environmental reports
   - future prospects report

c. Corporate Reports
   - transfer pricing
   - foreign currency translation
   - earning remittance
   - the effect of inflation

C9: To what extent should the role of Central Agency for Auditing be taken into consideration?

C10: What is the role of the Ministry of Planning in the review of foreign enterprise reports?
1. Financial reports
2. Non-Financial and Social reports
3. Corporate reports.

C11: Where, in your opinion does the main responsibility for the control process lie?

- The General Authority for Foreign Investment Board
- The Central Agency for Auditing
- The Ministry of Planning
- The supervising ministry
- The General Companies Administration
- Others. Please specify and comment.

C12: How should these reports of foreign enterprises be monitored and investigated?

1. Financial control
2. Administrative control
3. Legal control
4. Others

C13: What is the process of controlling and evaluating the results of foreign enterprises individually to ensure that the objectives are achieved as effectively and efficiently as possible?

1. Financial and compliance audit
2. Effectiveness and efficiency audit
3. Comparing results with objectives
4. Other comments.

C14: What is the relevant system for recording the results of foreign enterprises transactions and decisions?

1. Historical cost
2. Current cost
3. Other comments.

C15: What is the method used for translation of foreign enterprise’s statements?

1. Current rate method
2. Historic rate method
3. Current and non current method
4. Monetary/no-monetary method.

Please specify and give comments.

C16: What are the major issues that arise throughout the financial control process?
1. The remittance of funds in terms of profits, royalties, fees and interests.
2. Foreign exchange translation /transactions problems
3. Transfer pricing policies
4. The amount of tax revenue and interest rates
5. Price control
6. Others. Please specify and give comments.

C17: Should there be any restriction on the amount of earning and capital remitted abroad by a foreign enterprise?

Yes ___   No ___   If yes/no please show

C18: What kind of tax allowances must the Egyptian tax/legislation make when foreign enterprise declares earnings?

C19: What investigation is made of foreign enterprises' reports for tax purpose?

C20: Do foreign enterprises pay their fair share of Egyptian taxes?

C21: If the answer is Yes, which tax burdens are imposed on operating enterprises?

- Income taxes
- Other. Please give details.

C22: If the answer is No, what are the reasons?

- Would it be possible for you to supply the figures for the last four years? If so please give these data.

C23: In what principal ways do taxes on MNE's subsidiaries differ from taxes on domestic business?
C24: Should there be an exchange control restriction by the Egyptian Government?

Yes ____  No ____

C25: If affirmative, could you explain what you believe should be foreign exchange policy and control in terms of:

1. Imports of key raw materials and goods which can enter the country
2. Payment for services
3. Remittance of profits, dividends etc.
4. Capital transactions
5. Exports
6. Other

C26: Which of these practices exist now?

C27: What type of exchange rate is used?

1. Official exchange rate
2. Preferential exchange rate
3. Prevailing exchange rate
4. Multiple exchange rate

C28: Who has the right to carry out foreign exchange policy and control?

1. Ministry of Finance
2. The National Bank of Egypt
3. Any of the authorized banks
4. Others. Please comment.

- How much foreign exchange earning has been created in the last four years by foreign enterprises?

C29: What are the main purposes of the exchange control system regarding the balance of payments position?

C30: Is manipulation of transfer pricing by foreign enterprise a serious problem?

Yes ____  No ____
C31: What is, in your opinion, the best way to control this phenomenon by the Egyptian Government? Please give details.

C32: What are the techniques used by the Egyptian Authorities regarding administrative control process?
- Production control
- Employment control
- Value added
- Quality control
- Others

C33: Who has the responsibility for carrying out these techniques?
- The General Authority for Foreign Investment
- The Central Agency for Auditing
- The General Companies Administration
- The Supervision Ministry
- The Ministry of Planning
- Others

C34: Do you consider that the Egyptian Government system of control over foreign enterprises is sufficient and adequate at present?
Yes ____ No ____

C35: If No, do you think it is possible for future changes to be made to control MNE’s?

D Contribution of foreign enterprises to the Egyptian economy

D1: In terms of Egypt’s economic interests, which form of foreign enterprise is preferable in the case of a new project or the take-over of an existing one?
1. Foreign wholly-owned
2. Joint-venture
3. Other. Please specify.

D2: In your opinion, have the benefits to the Egyptian economy been maximised by existing foreign enterprises over the last four years according to criteria adopted previously?
Yes ____ No ____
1. Employment output
2. Export
3. National output
4. Taxation
5. Balance of payments

D3: If the answer is Yes, in the case of employment output, what has been the extent of the real contribution both generally and within the Hilton Hotel and Squibb Egypt Company over the last four years, in terms of real contribution


1. The number of employees both in total and segmented by geographical area, sectors, and the individual subsidiary

2. Labour turnover

3. Employee costs (including social and training)

4. Other

D4: Approximately what percentage of total employees and costs have foreign enterprise's employees and costs represented over the last four years?

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<tr>
<td>Percentage range</td>
<td>N</td>
<td>C</td>
<td>N</td>
<td>C</td>
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<tr>
<td>1%-10%</td>
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<tr>
<td>11%-25%</td>
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<tr>
<td>More than 25%</td>
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D5: What have been the actual contributions to export which have directly resulted from foreign enterprises over the last four years?

<table>
<thead>
<tr>
<th>Year</th>
<th>Sector</th>
<th>Size</th>
<th>Value</th>
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<tbody>
<tr>
<td>1983</td>
<td></td>
<td></td>
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</tr>
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<td>1984</td>
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<td>1985</td>
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<tr>
<td>1986</td>
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<tr>
<td>TOTAL</td>
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</table>

D6: What percentage of foreign enterprises' sales have been exports compared to their total sales, during the last
four years?

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Sales</th>
<th>Export</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1984</td>
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<td></td>
</tr>
<tr>
<td>1985</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>1986</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

D7: Roughly what percentage of the country's total exports have foreign enterprises exports represented over the last four years?

1. 10%-20%
2. 20%-30%
3. More than 30%

Please comment.

D8: To what extent has the pattern of exports/imports from/to Egypt changed as a result of the existence of foreign enterprise over the last four years?

1. Not at all
2. To a small extent
3. To a large extent

D9: What have been the actual product effects of foreign enterprises on gross national product over the last four years?

<table>
<thead>
<tr>
<th>Year</th>
<th>Sector</th>
<th>Size</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td></td>
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<tr>
<td>1984</td>
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<td>1986</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

D10: Approximately what percentage of GNP have foreign enterprises' output represented over the last four years?

1. 5%-10%
2. 10%-20%
3. More than 20%
D11: To what extent has the rate of economic growth changed as a result of foreign enterprises' impact in general and of the Hilton Hotel and Squibb Egypt in particular over the last four years?

1. No change
2. Small increase
3. Moderate increase
4. Large increase.

Please specify and comment.

D12: How much have foreign enterprises paid in direct and indirect taxes during the last four years?

D13: Approximately what percentage of total Government taxes has been paid by foreign enterprises paid during the last four years?

1. 10-20%
2. 20-30%
3. More than 30%

D14: In your opinion, have foreign enterprises made a greater or lesser contribution to the Egyptian balance of payments over the last four years, compared with previously?

Yes ___ No ___

D15: If Yes, what have been the average direct contribution (taxes, export gain, foreign exchange earning, etc) of foreign enterprises to the Egyptian balance of payments over the last four years of operation? Please give details and supply data.

D16: If the above contribution has been negative, where is action by the Government required to encourage foreign enterprises to

1. Employ more people
2. Export more
3. Import less
4. Change their production methods
5. Change their policies
6. Other

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- To what extent should this action specifically directed to foreign enterprises and to what extent to affecting the disposition of resources as a whole?

D17: What alternative, should Government authorities adopt in order to evaluate the contribution of foreign enterprises to the Egyptian economy in the future?
Appendix -3

List of Interviewees

1. Ministry of Planning
   * Deputy Minister, Foreign Investment Department.
   * Head of Foreign Investment Department.
   * Deputy Minister, Pharmaceuticals Department.
   * Head of Pharmaceutical Department.

2. General Authority for Foreign Investment and Free Zones
   * Deputy Chairman of the Board of Directors of the Authority
   * Head of Performance Evaluation and Follow-Up Department.
   * Head of Information and Research Department.

3. General Companies Administration
   * Chairman of General Companies Administration.
   * Head of Companies Department.
   * Head of Performance and Control Department.

4. Directorate General of Foreign Currency
   * General Director.
   * Head of Foreign Investment Control Department.
   * Head of Information and Research Department.

5. Tax Administration
   * General Director of Foreign Investment Tax District Office.
   * General Director of Joint Stock Companies Tax District Office.
   * General Director of Statistical Department.

6. Health Ministry, General Organisation of Drugs
   * General Director of the Organisation.
   * Head of Planning and Follow-Up Department.
   * Head of Imports Department.

7. General Money Market Authority
   * Deputy Chairman of Authority Board.
   * General Director of the Authority.
   * Head of Foreign Companies Department.

8. Central Agency For Auditing
   * Chairman of the Agency.
   * Deputy Chairman for Foreign Investment Accounting
Sector.
* Director of Foreign Investment Accounting Sector.
* Director of Pharmaceuticals Accounting Sector.

9. **Squibb Egypt**

* General Manager.
* Financial Manager.
* Personnel Manager.
* Purchase Manager.
* Sales Manager.
* Laboratories Manager.


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