CORPORATE GOVERNANCE AND FINANCIAL
RESTATEMENTS EMPIRICAL EVIDENCE
FROM PAKISTAN

Haniya Tariq¹, Nadia Iftikhar² and Iftikhar-ul-Amin³

Abstract

The financial scandals around the world have greatly challenged the way financial reporting plays its role in corporate governance mechanisms. The present study empirically tests if corporate governance attributes lead to the possibility of restatements in financial statements. Logistic regression has been applied on data from 90 PSX listed companies. In addition to governance variables, firm specific variables like size, age, financial structure have been tested for their role in the financial restatements taking place in a company. The results reveal that an independent board of directors significantly reduces the incidence of financial restatements. Thus independent directors can efficiently oversee the function of financial reporting. Similarly, an independent audit committee significantly influences financial restatements. Thus accounting restatements could be reduced with strong governance inside the corporations. These results carry implications for the corporate regulatory bodies and the overall corporate governance framework in Pakistan.

Keywords: Financial Restatement, Corporate Governance, Audit Committee, Framework.

JEL Classification: M480

Introduction

Agency conflicts in companies with separate ownership and management calls for effective mechanisms of corporate governance. This is inevitable if the interests of shareholders’ in particular and of all the stakeholders in general are to be safeguarded. This is achieved by ensuring that all essential control mechanisms are in place and working properly. It helps to mitigate the risk of possible future failures before they occur.

Corporate Governance refers to the mechanism that addresses agency conflicts encountered as the ownership and control of a company is separated (Fernando, 2009). The OECD

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¹Management Trainee Officer ,Askari Commercial Bank, Former research student at Institute of Management Sciences,Peshawar,Pakistan. Email:Haniyatariq1@gmail.com
²Assistant Professor, Institute of Management Sciences ,Peshawar, Pakistan. Email:nadia.qadir@imsciences.edu.pk
³Assistant Professor, Institute of Management Sciences,Peshawar,Pakistan. Email: iftiikharulamin@imsciences.edu.pk
refers to this phenomenon being the system which gives direction to business corporations and controls their operations. It has also outlined the rights as well as the responsibilities associated with different roles in a corporate entity e.g. shareholders, board of directors, management etc. rules and regulations regarding corporate decision making also come under the domain of corporate governance.

Corporate governance becomes all the more important in developing countries like Pakistan where the implementation of law is weak. Agency conflicts in such countries are more intense. The reason is that most large companies are owned by families and the top management positions are also held by family members (Cheema, Bari, & Siddique, 2003). Corporate governance is not just about the decision making by directors but also about the manner in which organizations could be held accountable for their doings. Financial reporting is one yardstick through which the management of a company could be held answerable to shareholders and has to meet certain targets to keep the shareholders satisfied. When it is unable to meet those targets or when it wants to cover up bad performance, it begins to misstate its performance. To solve this problem, the corporate governance mechanisms need to be adapted and improved continuously.

The present study aims to explore whether corporate governance attributes might influence the financial restatements done by companies. This aim is achieved through a comparison of the corporate governance mechanisms of those firms where financial restatement was done with firms where financial restatement did not take place. This comparison helps to examine the differences between the two sets of firms in terms of their corporate governance mechanisms.

**Literature Review**

Corporate governance, among other activities also encompasses the financial reporting of a firm. It is no more considered a low-priority bookkeeping activity (Berndt & Leibfried, 2007). According to Berndt and Leibfried (2007) information is needed for two purposes: from an economic viewpoint, for the efficient allocation of resources, and from a legal viewpoint, for the protection of investors. Without reliable information, stakeholders are not in a position to assess a company’s performance and allocate resources efficiently. Cotton (2002) observes that financial reporting was the root cause behind the corporate frauds leading to major financial losses over the past several years. Unfortunately, in the past there have been many instances of material restatements relating to financial reports. The integrity of the board of directors, external and internal auditors has become questionable in wake of the demise of many corporate stalwarts. At the same time investors have also become apprehensive of the firms where they could possibly invest. Restatements may be due to fraud or error and research shows that market reactions to restatements indicating fraud are more severe than restatements indicating errors (Palmrose et al., 2004). However, similar findings by Hennes, Leone and Miller (2008) put misstatements into errors and irregularities, and not frauds. Nevertheless, this does not mean that restatements are appreciated. Kinney and McDaniel (1989) and Turner, Dietrich, Anderson, and Bailey (2001) are also of the view that firms engaged in revisions
in their financial statements face sharp decline in the share prices upon disclosure of the said activity.

**Causes of Financial Restatements**

Several reasons have been observed to cause financial misstatements and restatements. Plumlee and Yohn (2010) investigated the motives of restatements. They classified restatements into 4 categories based on causes of restatements in their data set that are (1) an internal error by the company (2) intentional manipulation by the company (3) complex nature of the transaction being recorded (4) improper application of the accounting standards. Their results complied with the generally held views about the complexity of the accounting standards being the major reason for restatements. The same view is held by Ciesielski and Weirich (2006). Another reason for financial restatements is the presence of numerous accounting standards.

Dzinkowski (2007) argues that companies have a hard time trying to find the relevant accounting standards as they carefully go through thousands of pages of accounting standards. Kellogg and Kellogg (1991) found that companies manipulate financial statements to entice investors to buy their stocks and bonds thereby increasing the value of their stock for existing stockholders. Similarly, Dechow et al. (1996) attributed the access to low cost financing as the prime motivation for companies to do earnings management which ultimately leads to restatement. Finally, some studies conclude that the instance of financial restatements increases due to the pressure companies face to meet earning targets ultimately leading to earnings management these earnings management when unveiled have to be restated (Plumlee & Yohn, 2010).

Financial Restatements have often been used as indicating earnings management (Desai et al., 2006), ineffective corporate governance practices (Srinivasan, 2005), quality of accruals (Doyle et al., 2007), as well as lack of experience of financial executives leading to internal company errors (Aier et al., 2005).

**Corporate Governance and Financial Restatements**

Abbot, Parker and Peters (2004) reveal that financial restatements is a consequence of weak corporate governance mechanisms. Similar view is shared by Agrawal and Chadha (2005) and Efendi, Srivastava, and Swanson (2007). Farber (2005) reports that the companies doing fraud through financial reporting (which ultimately leads to restatement when frauds are exposed) have certain characteristics: firstly their boards are less diversified with less expertise; consists of few independent directors and the audit committee meets less often. Few of these firms carried audit through the Big 4 auditing firms and majority had a single person carrying out the dual role of CEO-Chairman in comparison with non-fraud firms before the fraud is surfaced.

A formal and systematic approach towards corporate governance started off with the
introduction of the first code of 2002. This also paved the way for increased interest of academicians and practitioners in this area in Pakistan. Compliance with the code has resulted in improvement in the financial reporting quality of Pakistani businesses (Rais & Saeed, 2005). This improvement has added to the accountability and transparency associated with financial reporting. Reviewing the Pakistani literature on corporate governance shows that a major part of the literature strives to develop a connection between attributes of corporate governance and how they impact the profitability of companies in textile sector, banking sector, oil and gas sector and cement industry, (Yasser, 2011; Azeem et al., 2013; Dar et al., 2011; Rehman & Hussain, 2013; Zaman et al., 2014; Inam & Mukhtar, 2014; Yasser et al., 2011). However, there is not much work done on corporate governance and financial restatements which provides an opportunity for further research in this area.

**Methodology**

*Defining Variables*

*Independent variables*

Board Size signifies how many directors are appointed to the board that oversees and monitors the management in the company (Cheng, 2008; Linck et al., 2008). Information regarding this variable is generally contained in the corporate annual reports.

Board Independence refers to the degree of independence enjoyed by the board of directors. It is taken to be the percentage of outside/non-executive directors on the board (Beasley, 1996). An independent director is expected to be free of any influence from the company, and hence, should be able to bring his expertise and knowledge to the decision making process without any affiliation or influence from the firm (Beasley, 1996). Data on Board Independence has been extracted from the annual report of a company. This is a dummy variable which is taken 0 if one-third of the board members are not independent directors, and 1 otherwise.

Audit Committee Independence is proxied by number of outside directors serving as part of the audit committee (Beasley, 1996). Information related to the composition of the Audit Committee is also accessed from the corporate annual reports. In the present study, if 50% of the members of this committee are non-executive, the dummy variable is coded 1, otherwise 0.

The Big 4 Audit Firms refer to the top four largest audit firms around the world. These big 4 audit firms along with the local members in parenthesis are: KPMG (KPMG TaseerHadi & Co.), Price Water House Coopers (A.F. Ferguson & Co.), Ernst & Young (EYFord Rhodes SidatHyder) and Deloitte Touche Tohmatsu (Deloitte Yousaf Adil & Co.). Information about the external auditor of a company is available in the annual report of a company. If a company has one of the Big 4 auditors as its auditor this variable is coded 1, otherwise 0.

4 SBP BPRD Circular Letter No. 20
CEO-Chairman Duality is when the CEO also serves as the Chairman of the Board (Chen et al., 2007). Information about CEO-Chairman Duality is available in the annual report of a company. If CEO-Chairman Duality is present, it is coded 1, otherwise 0.

Firm age is the time period that the company has been in operations taken in number of years. The information has been extracted from the companies’ websites.

Firm size is proxied by natural log of the total assets of the firm as done by Klai and Omri (2011) and Agrawal and Chadha (2005).

Leverage signifies the riskiness of a business. It is proxied by the ratio of total liabilities to equity as used by Agrawal and Chadha (2005) and Klai and Omri (2011).

Profitability has been proxied by the return on assets. This ratio is calculated using total operating income to total assets following Agrawal and Chadha (2005).

**Dependent variable**

“Restatement occurs when a company, either voluntarily or prompted by auditors or regulators, revises public financial information that was previously reported” (US Government Accountability Office, 2002, p.1). Restatement was measured by comparing the financial statements of a company for the same year from its 2 consecutive annual. If a difference in figures was observed i.e. a restatement, this variable was coded as 1, otherwise 0.

**Hypotheses**

The strength of corporate governance mechanisms is inversely linked with financial restatements (Abbot et al., 2004; Agrawal & Chadha, 2005; Efendi et al., 2007) while some studies have found mixed evidence. Agrawal and Chadha (2005) report absence of any relationship amongst board independence and restatement; whereas Lin et al. (2006) reports same results for audit committee independence and restatement. These mixed views lead us to test empirically if there is any relationship between corporate governance attributes and financial restatements.

Furthermore, Corporate governance has been measured using 5 proxy variables that are board independence, boardsize, presence of audit committee, audit committee independence and CEO-Chairman duality. The sub-hypothesis for each proxy variable is as follows:
**Board Independence (Sub-Hypothesis 1)**

Klein (2002), Effendi et al. (2007), and Beasley et al. (2000) reported about companies having more independent boards had better standards of financial reporting. However, Larcker et al. (2007) and Abbot et al. (2001) do not support this notion. Brickley and James (1987) and Rosenstein and Wyatt (1990) argue that larger number of outsiders constituting the board are more effective than boards having greater number of insiders while Agrawal and Chadha (2005) report the absence of any relationship between these two variables.

\[ H_0 = \text{Occurrence of financial restatements is not influenced by board independence} \]
\[ H_1 = \text{Occurrence of financial restatements is influenced by board independence} \]

**Board Size (Sub-Hypothesis 2)**

Yermack (1996) revealed that companies having smaller boards were better performers than firms who had larger boards. However, Jensen (1993) gives a contradictory view that small sized boards which had less than 7 members were more effective but equally more difficult for the CEO to control.

\[ H_0 = \text{Occurrence of financial restatements is not influenced by board size} \]
\[ H_2 = \text{Occurrence of financial restatements is influenced by board size} \]

**Audit Committee Independence (Sub-Hypothesis 3)**

Beasley et al. (2000) contended about independent audit committees being responsible for reducing the likelihood of a company indulging in financial misreporting while Agrawal and Chadha (2005) as well as Lin et al. (2006) found no evidence of any relationship between audit committee independence and the probability of restatement.

\[ H_0 = \text{Occurrence of financial restatements is not influenced by AC independence} \]
\[ H_3 = \text{Occurrence of financial restatements is influenced by AC independence} \]

**The Big 4 Auditors (Sub-Hypothesis 4)**

Audit firms that are bigger in size have achieved economies of scale but face reputational risk at the same time. Such firms are in a better position to provide high quality audit services (De Angelo, 1981). Auditors’ name, audit quality has been directly linked to the chances of uncovering financial statement fraud (Deis & Giroux, 1992; Palmrose, 1987). Farber (2005) is of the opinion that firms issuing fabricated or manipulated financial statements are less likely to engage a Big Four audit firm for their audit services. In the same vain, Francis and Wang (2008) report that occurrence of earnings management is generally lower for companies hiring the Big Four audit firms as their auditors.

\[ H_0 = \text{Occurrence of financial restatements is not influenced by presence of Big Four auditors} \]
H4 = Occurrence of financial restatements is influenced by presence of Big Four auditors

CEO-Chairman Duality (Sub-Hypothesis 5)

Firms engaged in earnings management had greater chances of having CEO-chairman duality (Dechow et al., 1996). The probability of financial misstatements is more for firms where there is CEO-chairman duality (Effendi et al., 2007; Jensen, 1993). Farber (2005) also argues that firms issuing fabricated financial statements are more likely to have CEO-chairman duality.

H0 = Occurrence of financial restatements is not influenced by CEO-Chairman duality

H5 = Occurrence of financial restatements is influenced by CEO-Chairman duality

The aforementioned hypotheses are tested by applying logistic regression. The objective of this study could be achieved by using logistic regression. It is suitable for use in situations where unequal sampling from two populations (control firms and restatement firms) takes place (which is the case in this research). Under this method, the unequal sampling does not affect the coefficients of the independent variables (Madala, 1991). A dichotomous dependent variable that can take only binary number calls for the use of logistic regression. This is evident in many other relevant studies (Beasley, 1996; Agrawal & Chadha, 2005; Lin et al., 2006; Dechow et al., 1996; Abdullah et al., 2010; Soroushyar & Ahmadi, 2013). In the present study, financial restatement which is the dependent variable is also dichotomous in nature with outcomes as either yes or no.

Data Collection and Sampling

Data of 90 companies listed on PSX have been taken for the time period of 2010-2014. The published annual reports of these companies have been the source of the data. These annual reports have been accessed via company websites.

Analysis

The results of the logistic regression encompassing the relationship of corporate governance attributes and financial restatements are presented in Table 1.
Table 1
Results of Logistic Regression

<table>
<thead>
<tr>
<th>Variable</th>
<th>β</th>
<th>Sig</th>
<th>Exp(β)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BoD Independence</td>
<td>-1.026</td>
<td>.000***</td>
<td>.359</td>
</tr>
<tr>
<td>BoD Size</td>
<td>.170</td>
<td>.752</td>
<td>1.185</td>
</tr>
<tr>
<td>AC Independence</td>
<td>1.405</td>
<td>.002***</td>
<td>4.075</td>
</tr>
<tr>
<td>Big4 Auditors</td>
<td>.237</td>
<td>.329</td>
<td>1.268</td>
</tr>
<tr>
<td>CEO/Chairman Duality</td>
<td>-.291</td>
<td>.298</td>
<td>.747</td>
</tr>
<tr>
<td>Firm Size</td>
<td>-.051</td>
<td>.436</td>
<td>.950</td>
</tr>
<tr>
<td>Firm Age</td>
<td>.205</td>
<td>.220</td>
<td>1.227</td>
</tr>
<tr>
<td>Leverage</td>
<td>.025</td>
<td>.184</td>
<td>1.025</td>
</tr>
<tr>
<td>Profitability</td>
<td>-.405</td>
<td>.491</td>
<td>.667</td>
</tr>
<tr>
<td>Constant</td>
<td>-1.638</td>
<td>.262</td>
<td>.194</td>
</tr>
</tbody>
</table>

The results support the acceptance of hypotheses H1 which states that board independence significantly influences financial restatement. These results confirm to the findings of Beasley (1996). H2 states that board size has a significant impact on financial restatement. However, the pertinent result is not statistically significant hence H2 is not supported. H3 predicts that audit committee independence has a significant impact on financial restatement. Results support this hypothesis. However, the finding is generally unsupported by previous literature. In Pakistan, majority members of an audit committee are non-executive directors who may not be “truly” independent and probably may not be in a position to perform their job properly.

H4 states that the Big-4 auditors have a significant impact on financial restatement. The results show that this finding is not statistically significant and hence, H4 is not supported.

H5 relates to the relationship of CEO-Chairman duality and financial restatement. But the results do not support H5.

The results reveal a negative although statistically insignificant relationship between size and restatement. Older firms are more well-known and they would not want to indulge in financial restatements that would tarnish their image. But the relationship of age and restatement is positive. The positive sign of debt to equity increases the probability of restatement although this result is statistically not significant. This finding makes sense as firms that are more leveraged can be tempted to misstate figures in order to avoid violating debt covenants. Lastly the negative sign of operating income shows that as the ratio of operating income to total assets increases the probability of restatement decreases but as the p-value is 0.491, this result is not statistically significant. This
result also makes sense as firms which are already making profits would have no reason to overstate profits.

Table 2

<table>
<thead>
<tr>
<th>Observed</th>
<th>Predicted</th>
<th>Percentage correct</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restatement</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>0</td>
<td>169</td>
<td>62</td>
</tr>
<tr>
<td>1</td>
<td>92</td>
<td>101</td>
</tr>
<tr>
<td>Overall percentage</td>
<td></td>
<td>63.7</td>
</tr>
</tbody>
</table>

Table 2 presents the model diagnostics. It also highlights the overall explanatory power of the model. The term “Overall Percentage” which is equal to 63.7% shows the extent to which the independent variables explain the variability in the dependent variable.

Conclusion

The demise of large corporations like Enron and WorldCom due to corporate frauds led to increased demand for legislation regarding corporate governance. In the US, the Sarbanes-Oxley Act in 2002 marked a significant step in this direction. Its effect became evident in Pakistan as well when the Code of Corporate Governance, 2002 was introduced. This point forward, academia and practitioners developed interest in this area. However, corporate financial reporting still remains underexplored for research. This research is a step in that direction.

The prime objective of this research was to study if financial restatements are driven by corporate governance attributes. However, looking at the results revealed the direction of relationship as well. Board independence significantly influences the chances of restatements. Specifically, an increase in board independence decreases the odds of restatement by 0.359 times. Results also show that audit committee independence significantly impacts restatements while the other variables that are CEO-Chairman duality, the Big-4 auditors and board size have an insignificant impact on financial restatements. The direction of the significant relationship between audit committee independence and restatements is positive. The reason for such a result might be that in Pakistan majority members of an audit committee in reality and by requirement of the Code of Corporate Governance, 2012 are non-executive directors. Apparently these non-executive directors may not be associated with the company in any capacity but in reality may not be “truly” independent. That is why they may not be in a position to perform their job properly.
As mentioned earlier there are many avenues to explore in this area. Further research with the same and additional variables can be carried out for other firms to check the significance of results. Comparison between corporate governance attributes of different sectors and their impact on financial restatements or specifically earnings management can also be checked.

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