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Is Pakistan's Financial Distress Guilty of Accounting Misrepresentation? A Manager's Mediating Role Due to Overconfidence

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Abstract: *This study's main goal is to determine the connection between accounting misrepresentation, managerial overconfidence, and financial distress among managers. Research indicates that there is a considerable correlation between financial distress and accounting misrepresentation. This problem has two aspects. Firstly, the management is under pressure to show the business's performance anytime there is financial trouble, but in reality, the business's performance deteriorates as a result of the financial distress. Stated differently, managers tend to manipulate their financial records at times of high uncertainty in order to win over the trust of their stakeholders and shareholders. Finally, the possibility of accounting fraud materializes if the firm's assessments, which are intended to avert charges of incapacity, are not met. A panel data regression model will be utilized to perform an empirical analysis of the hypothesis. For this study, panel data regression analysis was selected because it provides thorough insights into both cross-sectional and time-series data. The dataset includes data from 30 Pakistani companies that are listed on the Pakistan Stock Exchange, selected to represent a sample of the country's economy between 2010 and 2022. The study lays the groundwork for future investigations by recommending the use of corporate governance to control financial distress, managerial overconfidence, and accounting misstatement.*

Key Words: Managerial Overconfidence, Accounting Misrepresentation, Financial Distress, FGLS

Introduction

In the last ten years, a great deal of research has been done in the fields of finance and accounting regarding the effects of accounting misstatement, especially with the introduction of archival metrics of managerial overconfidence. Financial reporting inaccuracy is significantly impacted by managerial overconfidence. According to the bulk of studies in this area, a manager who often overestimates the likelihood or future returns of the company's projects is considered overconfident (J. Shekarkhah, M. Nikravash, & M. J. I. J. O. E. R. Adlzadeh, 2019b; Shima, Nakamura, & Investment, 2018). Because of this, it's critical to understand how managerial arrogance affects financial reporting misstatement. It may result in a decrease in the usefulness of the information, particularly for external users who have less access to a greater variety of data and reports. According to behavioral research, managers who are overconfident are less likely to consider all of their options when determining whether a project will succeed or fail. It is anticipated that these managers' future financial reports will contain inaccuracies based on past enhancements with respect to this aspect of their estimations. Overconfident managers make mistakes that accumulate over time and gain significance since they don't look for the causes of their past mistakes (Persley and Abbott, 2013). Overconfident managers falsify accounting or financial reporting in an attempt to avoid these reporting problems.

However, since managers make business decisions, management personality traits can play a part in predicting future financial difficulty for a company. For instance, the capital structure, investment choices, and business strategy of the company are heavily influenced by directors and executives. Remarkably, little information exists suggesting that overconfidence among senior executives and directors could be a sign

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of a company's impending financial distress. Managers who are overconfident and over-optimistic typically overextend themselves financially because they feel they will be able to escape any potential challenges. They undervalue the risk that their current borrowing levels and anticipated future income will be out of balance, as well as the possibility that a small amount of additional borrowing could cause serious financial troubles.

Similar to this, during a financial crisis, businesses manipulate accounting profit as a performance-measuring component (Campa, 2015; Li, Li, Xiang, Djajadikerta, & Economics, 2020; Ranjbar & Amanollahi, 2018). In many cases, management manipulates accounts to keep profits under control, hoping to minimize corporate depreciation while also providing positive information to the capital market. Businesses require adequate resources to stay in operation, including enough money to pay back loans. If the business cannot meet its demands, it will face financial difficulties. Companies misuse accounting profit as a performance evaluation factor during hard times. If the financial statements are altered, their existential philosophy will be disproved, and their credibility can be eliminated. Therefore, the impact of managerial overconfidence and financial distress on financial reporting misstatement will be empirically evaluated in this study.

Problem Statement

Investors and other stakeholders lose faith in a company's financial statements when it announces a restatement. It conveys a message to investors that the financial statements published up to this point have been of poor quality (Chakravarthy, DeHaan, & Rajgopal, 2014). When corporations publish restatements, it is not uncommon for stock prices to collapse for investors or regulators to sue (Mao, 2018). Furthermore, the management's honesty and competency are being called into question. When fraud is involved, the consequences are magnified (Yin & Sun, 2021). When a company's stock price falls below a certain threshold, it may be forced to declare bankruptcy and be delisted from the national stock exchange (Murhadi, 2010).

Misrepresentation of company facts in financial reporting is growing increasingly widespread, resulting in accounting misstatements (Moradi, Salehi, Najari, & Technology, 2012). Shareholders lose interest in companies or are unable to understand the organization's financial situation. Accounting misstatement is occasionally used to defraud the government about taxes. Some businesses maintain two books of accounts, one for internal use and one for public consumption, which can result in accounting problems. Accounting misrepresentation is triggered by two factors: managerial overconfidence and financial distress. However, according to recent research (Rashid, Al-Mamun, Roudaki, & Yasser, 2022), IFRS (International Financial Reporting Standard) is critical for implementation due to its numerous benefits, including comparative attributes and resource allocation, better investments, diversified portfolios, and better financial statements. It is also cost-effective because it establishes rules based on entity status.

Many studies have examined accounting misstatements in developed nations; however, there is still a dearth of research on the causes of accounting misstatements, especially in developing nations like Pakistan. Pakistan is one the developing Asian countries where there has been little research on accounting misstatements (Abdullah et al., 2010; Hasnan & Hussain, 2015; Wahab, Gist, & Majid, 2014). However, because of the biased variable selection, the results are not conclusive. Furthermore, cultural norms and regional differences may exist in SECP regulations, company environments, legal frameworks, and the caliber of financial reporting. As a result, discrepancies in findings are to be expected, particularly in the case of Pakistan. This study will now investigate the various characteristics of managerial overconfidence, financial distress, and accounting misrepresentation by researching the following research objectives, which translate into research questions for empirical investigation and hypothesis development.

Research Objectives

1. To find out the impact of managerial overconfidence on financial reporting misstatement
2. To explore the impact of financial distress on financial reporting misstatement
3. To investigate the impact of managerial overconfidence and financial distress on financial reporting misstatement

4. To conjecture the relationship among managerial overconfidence, accounting misstatement, and financial distress

Research Questions

1. Does managerial overconfidence influence the firm's financial reporting misstatement?
2. How does financial distress impact the financial reporting misstatement of the firm?
3. Does managerial overconfidence and financial distress impact the financial reporting misstatement?
4. Is there any relationship between managerial overconfidence, accounting misstatement, and financial distress?

Research Hypothesis

1. H_{A1}= There is a significant impact of managerial overconfidence on the financial misstatement of the firm
2. H_{A2}= There is a significant impact of financial distress on the financial misstatement of the firm
3. H_{A3}= There is a significant impact of managerial overconfidence and financial distress on the accounting misstatement of the firm
4. H_{A4}= There is a significant relationship among managerial overconfidence, accounting misstatement, and financial distress

Literature Review

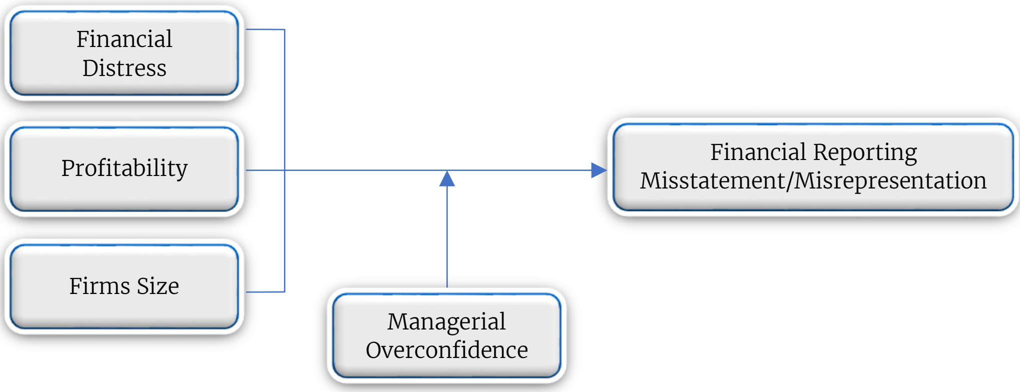
Managerial Overconfidence, Accounting Misstatement, and Financial Distress in Pakistan

The Security Exchange Commission of Pakistan is the regulatory authority responsible for overseeing and prosecuting businesses that engage in accounting fraud. However, despite the rise in financial schemes in Pakistan, SECP is unable to keep track of accounting misstatements. Furthermore, Pakistan's weak legal system and insufficient laws contribute to the country's high rate of financial misstatements. Penalties levied against these owners are not proportionate to the financial impact of these false claims, despite SECP's lack of accounting misstatement records as a regulator; hence, it seems that enforcement is currently comparatively lax (Verschoor, 2014). Companies found guilty of fraudulent misstatement were subject to fines, required to restate their financial accounts, and were allowed to keep their jobs. But the only things that can stop the misrepresentation are stringent restrictions and delisting threats. The issue of accounting deception has been extensively studied in industrialized nations, whereas emerging economies have received far less attention (Lau & Ooi, 2016). Pakistan and other developing Asian nations have been the subject of very little research on accounting misrepresentation (Azhari, Hasnan, & Sanusi, 2020; Latif & Abdullah, 2015). Due to variations in legal frameworks, corporate structures, cultural norms, regulatory environments, and the caliber of financial reporting, outcomes may differ between nations. This is particularly valid when contrasting developed and developing countries (Dechow, Ge, Larson, & Sloan (2011); S. N. Abdullah, Yusof, & Nor, 2010). The underlying causes of accounting fraud differ between nations.

As a result, this study contributes fresh information to the expanding body of research on material accounting misrepresentation in developing nations like Pakistan. This study looked at the opportunities and motivations that can lead to significant accounting misrepresentation in Pakistan. This study evaluates the factors leading to material accounting misstatements, taking into account the impact of managerial overconfidence and financial distress, which are thought to affect a firm's decision-making and exert pressure on the company to engage in significant accounting misstatements.

Due to the inadequate enforcement of accounting rules and the meagerness of the penalties in place, there have been multiple examples of misrepresentation in Pakistan. Due to frequent instances of misrepresentation, the credibility of financial reporting is gradually declining. Poor financial reporting makes stakeholders and investors lose trust in the organization. If strict sanctions and fines are not implemented, misstatements will persist, and public confidence in financial reporting will be eroded. As a result, research is being done to determine the underlying factors that contribute to accounting fraud in Pakistan. In an effort to address the issue of significant accounting misstatements, this study investigated the origins and possible catalysts of these mistakes in Pakistan. The purpose of this study is to ascertain whether overconfidence on the part of managers and financial difficulties are related. Accounting errors are a concern as they frequently occur.

Conceptual Framework



Research Methodology

This study aims to bridge the knowledge gap in the current research by examining the relationship between managerial overconfidence and the incidence of financial distress and misstatements. The dimensions of the aforementioned research aims, expressed as research questions and hypotheses, are revealed in this study.

Operationalization of Variables

Measurement of Dependent Variable

The dependent variable for this research is accounting misstatements. It has been measured through the proxy of earning management. The modified Jones Model (1991) is the gold standard for estimating earnings management. It has outperformed several competing models in terms of identifying earnings management (Dechow et al., 1996; Hadani et al., 2011).

$$DAC_{it}=TAC\ it - [\alpha(1 / TA\ it -1) + \beta 1\ (\Delta\ REV\ it / TA\ it -1) + \beta\ 2\ (PPE\ it / TA\ it -1)] + \varepsilon\ it\text{-----}(I)$$

Whereas TAC *it* = aggregate accruals; TA *it -1* = the book value of total assets of firms i at the end of year t -1, Δ REVit / TA it -1 = sales revenues of firms i in year t fewer revenues in year t – 1, scaled by TA it -1; PPE it / TA it -1 = gross property, plant, and equipment of firms i at the end of year t, scaled by TAit -1; α β1 β 2 = estimated parameters; εit = the residual DACit= Discretionary accruals for firm i in year t

Some other studies' measurements are made likewise (Ahmadi, Banimahd, Talebnia, & Pourzamani, 2020; Merani & Taheri, 2018; Nanda, Zenita, Salimiah, & Adino, 2022).

Measurement of Independent Variables

The independent variables for this study are managerial overconfidence, financial distress, and some control variables like profitability and company size.

Measurement of Managerial Overconfidence

An unreasonable belief in uncertain outcomes, which frequently entails an underestimation of the likelihood of adverse effects, is what defines overconfidence (Salehi, DashtBayaz, Hassanpour, & Tarighi, 2020). This study employed the debt-to-equity ratio—a firm's capital structure variable—to assess managerial overconfidence in accordance with the guidelines provided by Ahmed & Duellman (2013) and Malmendier, Tate, & Yan (2011). For the specified financial year, this ratio was contrasted with the industry median. A dummy variable was used and coded as "1" if the value was greater than the median, indicating the presence of overconfidence; if not, it was coded as "0." Another strategy was taken into consideration, in which a company with high leverage—typically more than one—was thought to be a sign of managerial arrogance, and vice versa.

Measurement of Financial Distress

The Altman Z-Score was used to assess financial distress; this is a measure that has been used in other research to accurately determine the degree of financial distress (N. Gul, Qureshi, Elahi, & Rasool, 2018; Hennes, Leone, & Miller, 2008). The formula created by Altman (1968) was used to calculate the Z-Score:

Z = 1.2X1 + 1.4X2 + 3.3X3 + 0.6X4 + 1.0X5------(II)

- Where the ratio of working capital to total assets is represented by X1.
- The ratio of retained earnings to total assets is indicated by the symbol X2.
- The ratio of earnings before interest and taxes to total assets is represented by the symbol X3.
- The market value of equity in relation to all liabilities is represented by X4.
- The ratio of net sales to total assets is shown by X5.

Measurement of Firm Size

It is evaluated using the natural logarithm of total assets, as demonstrated by Hwang, Hwang, and Dong (2015) and M. D. F. Abdullah, Ardiansah, and Hamidah (2017).

Measurement of Profitability

As a measure of effectiveness, profitability is essential in deciding whether a business will succeed or fail. According to Abbas, Iqbal, and Aziz (2019), N. I. M. Aziz (2017), and O. G. Aziz & Knutsen (2019), this metric is used to assess a company's profit in relation to its market share.

Data

The study's sample consists of 30 companies that are listed on the PSX 100 index. These companies were chosen from a pool of 544 companies that were listed on the Pakistan Stock Exchange between 2010 and 2022.

Econometric Methodologies

Since there were more cross-sectional companies (subjects) N in this study than there were time periods, both unbalanced and short panels were investigated.

$$FR - Misstatement = \alpha + \beta_1 X_{Mo} + \beta_2 X_{FD} + \beta_3 X_{Prof} + \beta_4 X_{FS} + \epsilon_{it} ----- \text{(III)}$$

Descriptive Statistics

Table 1

Variable	Obs	Mean	Std. Dev.	Min	Max
AM	390	36.380	23.002	116	1617
FD	390	6.37	1.418	4	13
MO	390	0.864	0.121	.20	1.65
FS	390	16.044	4.130	9	35
PROF	390	1.103	.100	0	3

Source: Author own Developed

Regression Analysis

Regression Results

Table 2

AM	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
FD	201.663	4.860	32.30	0	219.021	211.406	***
MO	17.416	27.111	0.57	.401	-35.70	62.71	

AM	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
FS	-3.314	2.101	-1.88	.035	-8.56	-.06	**
Prof	-26.883	22.326	-1.08	.121	-63.84	16.850	
C	-989.422	55.999	-13.13	0	-1130.631	-757.523	***
Mean dependent var	464.811		SD depends on var			322.002	
r-squ	0.732		No of obs			390	
Chi-squ	3296.34		Prob > chi2			0.000	
R-squ within	0.887		R-squ bwn			0.65	

*** p<.01, ** p<.05, * p<.1

Source: Author own Developed

However, after the FE model was run, it discovered certain post-estimation disorders, so the following test was performed to ensure model robustness: When two independent variables in a multivariate regression equation have a significant relationship, it's known as multicollinearity. The statistical significance of an independent variable is compromised by multicollinearity. The V1IF test has been used to test it as follows.

Variance Inflation Factor
Table 3

	VIF	1/VIF
FD	1.736	.576
FS	1.724	.580
PROF	1.414	.707
MO	1.115	.896
Mean VIF	1.947	.

Source: Author own Developed

Assuming that multicollinearity is absent from the model, the mean VIF value is less than 10 (Rockwell, 1975). The heteroscedastic and auto/serial correlation problems in this research arise from the fact that all companies employ the same kind of indicators to measure the constructs. Thus, the model that follows has been used while evaluating the final model:

FGLS Regression
Table 4

AM	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
FD	200.419	3.415	58.69	0	193.727	207.112	***
MO	30.053	11.49	3.50	0	17.645	62.687	***
FS	-3.108	.845	-4.98	0	-5.865	-2.553	***
Prof	66.47	37.836	2.05	.04	3.424	151.737	**
Constant	-1035.19	42.919	-24.12	0	-1119.309	-951.07	***
Mean dependent var		463.801		SD dependent var		331.012	
Number of obs		390		Chi-square		7686.182	
Overall r-squared		0.734		Prob > chi2		0.000	

Source: Author own developed

The model's findings suggest that the model as a whole is noteworthy. 74% of R2 within entities is captured. It explains how variations in the independent factors affect the dependent variable. This analysis unequivocally demonstrates that operating income and cash flows as independent variables account for both firm success and failure. The F-statistic, which has a chi-square probability of less than 0.000 and indicates the model's relevance up to 99 percent, is also used to fit the overall model.

The values and signs of the model coefficients represent various images. According to Aviantara (2021), F. A. Gul et al. (2018) and Wu et al. (2016), for example, show that financial distress has a positive and significant impact on accounting misstatement or earning management. A 1% increase in financial distress will result in a 200% increase in accounting misstatement of earning management. Comparably, one unit change in managerial overconfidence will result in a 30% increase in accounting misstatement of earning management (Mitra et al., 2019; Presley & Abbott, 2013; Shekarkhah et al., 2019a). Managerial overconfidence also has a significant but positive impact on earning management.

As an alternative, firm size has a significant and negative effect on earning management or accounting misstatement; a one-unit change in firm size will result in a 3.1 percent decrease in making management accounting misstatement (Aier, Comprix, Gunlock, & Lee, 2005; Amel-Zadeh & Zhang, 2015; Hasnan et al., 2020). But profit has a big but positive effect on earning management or accounting misstatement; a one-unit change in a company's profitability causes a 66 percent increase in earning management accounting misstatement (Hasnan et al., 2020; Indracahya & Faisol, 2017; Rahmah & Iskandar, 2021).

Conclusion

The core aim of this study is to empirically evaluate the relationship between managerial overconfidence, financial distress, and accounting misstatement. This problem develops when an accounting error is deemed significant, and a word restatement will be demanded to address it. Therefore, as stated by Abbott, Parker, and Pet (2004) and Mohamed Hussain et al. (2016), the terms "misstatement" and "restatement" are used synonymously during the research process. According to Abdullah, Mohamad Yusof, and Mohamad Nor (2010) and Efendi, Srivastava, and Swanson (2007), financial restatement entails correcting values acknowledged, measured, and disclosed in a previous financial statement that deviates from Generally Accepted Accounting Principles (GAAP).

However, the results of the study confirm that managerial overconfidence and financial distress have a significant impact on accounting misstatement. This issue is twofold. One is that whenever there is financial distress, the manager has pressure to present the performance of the business, but in actuality, its performance worsens due to financial distress. In other words, in a period of high uncertainty or financial distress, managers often cook their books of account to achieve the confidence of their stakeholders and shareholders. The value of a company declines due to a financial crisis, which also impacts operational effectiveness and performance and jeopardizes managerial positions and reputations. Businesses may be forced into liquidation or bankruptcy if they cannot withstand the strain and bear the expenditures. These unfavorable outcomes could drive management to make accounting errors to hide their current predicament from the public. It encourages business managers to "cook the books" to enhance the firm's financial situation deceptively.

Additionally, it was discovered that enterprises in Pakistan, when found in financial hardship, are more prone to produce false accounting statements than successful businesses, which supports the previous finding. A company might make a false statement to acquire business possibilities, avoid debt covenant violations, and avoid being delisted from the stock exchange. Distressed companies will often manipulate to get a foothold in the corporate market. Managers may be compelled to make false statements to conceal declining performance since their positions and reputations are on the line.

Furthermore, managerial overconfidence significantly impacts accounting misstatement. Overconfident managers may employ aggressive accounting approaches to project profitability, resulting in irrational projections and skewed financing and investment decisions. Eventually, if the company makes poor decisions in an attempt to avoid being accused of incompetence, the possibility of accounting fraud materializes. This is particularly noticeable when overconfident managers have a large portion of their wealth invested in the company's shares, putting them at greater risk of idiosyncratic hazards and when the company's success has a big influence on their reputation and employability.

Therefore, a financial reporting statement that is skewed towards optimism would result if the optimistic expectations resulting from managerial overconfidence failed to materialize. Overconfidence has been identified as a distinguishing characteristic of companies that engage in overstatement compared to those that do not. According to this research, accounting inaccuracies are the result of earnings management employed to bring actual results in line with overly optimistic forecasts for future profits. This earnings management typically begins on a small scale. That being said, things can quickly get out of hand, leading an overconfident manager to greatly manipulate the financial statement to hide the real state of the company's finances. The most fertile area where management can use its discretions in reporting the financial statements:

- Expenses Recognition refers to capitalizing expenses to recognize accounting costs either in the current period or over time.
- *Revenue Recognition:* To change the company revenue picture or smooth for a period by booking sales too early or too late
- *Depreciation:* When determining how much an asset will depreciate, managers also select the assets' useful lives.
- *Inventory:* It is based on cost flow assumption (FIFO, LIFO, Weighted Average)
- Sorting occurrences into categories such as ongoing, one-time, or exceptional.
- Evaluating and devaluing goodwill and other intangibles
- Making suppositions when calculating benefits after retirement

Recommendations and Limitations

The Following are the Recommendations

- In cases involving managerial overconfidence and financial distress within companies, the Securities and Exchange Commission of Pakistan and the Pakistan Stock Exchange should place a high priority on improving the quality of financial reporting and setting standards for reporting quality.
- Policymakers must take into account the direct impact of accounting misstatement on the relationship between financial distress and managerial overconfidence when developing policies for listed companies. Putting incentive-based regulations into place can improve control over these two major variables.
- Institutional and minority investors should take these factors into account when making investment decisions, given the significant positive relationship between managerial overconfidence and financial distress that has been observed in high accounting misstatement firms compared to their low accounting misstatement counterparts in Pakistan's economies.
- Leverage can help reduce taxes, but it shouldn't come at the cost of a higher default risk. It is recommended that listed companies use an optimization strategy when deciding how much debt to include in their capital structure.
- The results of the study show that, especially in low-leveraged companies, accounting misstatement tends to increase with corporate leverage. Chief Financial Officers (CFOs) ought to consider that having less debt in the capital structure makes it easier for managers to report on the finances more accurately.

Limitations

There are various limitations to the study that need to be noted.

- First off, measuring accounting misstatement and discretionary accrual accounting are two different things, and future studies must take this into account—especially since GAAP permits managers to make discretionary accruals.
- Second, it would be beneficial to include in the study how corporate governance affects financial distress, managerial overconfidence, and accounting misstatement. This extra layer of information may offer a more thorough comprehension of the variables impacting financial reporting.
- Moreover, the companies in our data set are limited to a single nation. Even though both economies are sizable, testing the model in more nations could add insightful information to the body of current research.
- Moreover, a sample of 37 firms included in the PSX 100 index forms the basis of the study. Future studies might examine differences in managerial arrogance, accounting fraud, and financial distress amongst businesses in order to further the depth of the analysis. A more nuanced view could be obtained by breaking down the data set according to various parameters, such as industry type (e.g., innovative industries, green firms, polluting industries, etc.).

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