

## INVESTIGATING THE RELATIONSHIP BETWEEN FINANCIAL INCENTIVES OF EXECUTIVES AND THE REPRESENTATION OF FINANCIAL STATEMENTS

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### ABSTRACT

*Information asymmetry and personal incentives are two main causes of manipulation and distortion of financial statements. One possible strategy is to reward executives in an attempt to align the interests of owners and directors. The distortion and manipulation of information leads to the representation of financial statements. Therefore, the purpose of this study was to explore the relationship between financial incentives of executives and the representation of financial statements. The study was based on the library research and the analysis of panel data. It investigated the financial information of 108 companies listed on Tehran Stock Exchange Market from 2011-2017 (756 company-year). The results of hypothesis testing suggested that there was a significant positive relationship between the managers' rewards and the representation of financial statements. Also, there was a significant positive relationship between the board duality and the representation of financial statements. With regard to the significance level and the estimation coefficient, the independence of the board of directors, the board size and the concentration of ownership were inversely related to the representation of financial statements.*

**Keywords:** Representation of financial statements, reward of the board of directors, financial incentives of executives.

### INTRODUCTION

The main purpose of financial reports is to exhibit the economic effects of events and financial operations on the status and performance of a company to allow people outside the organization (external users) to make appropriate financial decisions. The main qualitative features that underline the usefulness of information are reliability and relevance. Consumers of financial statements place a special emphasis on the reliability of financial statements to make decisions about bonus and debt contracts, investments and the stock valuation. When financial statements are not reliable, they may lead to damages and losses of investors in at least two ways. Firstly, when the information is inaccurate, a revision would be required after a while, which yields a deteriorating effect on the calculations of investor to reach an appropriate decision. Secondly, fake information set forth by the manager in both preparation and presentation of financial statements will also exert a negative effect on investors' decisions. On the other hand, in recent years, the number of represented financial statements provided by companies has been considerably on rise (Nikbakht and Rafiee, 2012). This growing

number of representations exhibits the inaccuracy and unreliability of the financial statements published in previous periods. In fact, representation of financial statements undermines investors' confidence, trust and reliability, and casts doubt on the integrity and credibility of financial reporting (Saqafi *et al.*, 2011).

The information asymmetry between owners and managers of a company tempts managers to take the advantage of the situation to satisfy their personal interests (Tang and Sun, 2014). Managers' reward can be used as a solution to bridge the gap between the ownership and the management. This can boost the managers' incentive to manipulate the profit growth, which may result in the representation of financial statements. However, the board is responsible for monitoring the quality of information presented in the financial statements and they must ensure that the interests of shareholders, creditors and stakeholders are aligned (Khajavi *et al.*, 2015). Nonetheless, there are still some concerns about the suitability (competence) of the corporate governance (Pergola, 2006). In view of this, the present study discussed the financial incentive of the executives and its relationship with the representation of financial statements.

## LITERATURE REVIEW

The representation of financial statements is not a new phenomenon. However, in recent years, due to the aggressive accounting practices, fraud or accounting irregularities, the frequency and rate of representation of corporate earnings have soared significantly. Therefore, these days, investors, analysts and regulators have focused on representation (Wu, 2002).

According to Paragraph 13 of the Generally Accepted Accounting Principle (GAAP or U.S. GAAP) regarding accounting changes, the income representation and other financial information of previous years are essential due to the mathematical calculation errors, improper application of accounting procedures and the misinterpretation or disregarding of facts at the time of preparing financial statements. According to Palmrose and Scholz (2004), the main reasons for representation are revenues (e.g., incorrect or questionable income identification), costs (e.g., mistakes in capital expenditure), and re-classification and disclosure.

Hribar and Jenkins (2004) argued that companies in charge of representing financial statements tend to renew their own financial statements due to the issues related to income recognition, cost, operating costs, assets, and inventories.

Representation warns of the increased risk of information representation in the company, which is due to the diminished credit of financial statements and low accounting quality. Also, the representation may alert investors to the possible deterioration of the economic situation in the representation company (Palmrose and Scholz, 2004). Billings *et al.* (2014) posited that the representation is on rise due to the growing effort of executives, the board of directors and auditors in the review process, which has improved the transparency and the investors' confidence. Some studies have explored the relationship between the earning management and representation of the SOX law (Cohen *et al.*, 2008; Marciukaityte *et al.* 2009). Wilson (2008) studied the reduction in the information content of profits after the representation of financial statements. According to his results, the investors believed that the benefits derived from the representation were relatively less informative. One of the major consequences of implementing the SOX law is the proliferation of the representation notifications. Using a sample of representation companies from 1997 to 2003, Marciukaityte *et al.* (2009) found



that the probability of optional representations was positively correlated with the independence of the board of the directors and the audit committee.

On the other hand, Francis *et al.* (2008) found that the companies with a healthy interest quality had more discretionary disclosures than the companies with a poor performance. They suggested that with the enhanced quality of a company's information, the executives would be at liberty to disclose information more freely. In fact, the representation requested by the company's management and auditor have been necessarily optional (there has been no legal requirement or any statutory audit requirement for companies to represent profits). On the other hand, companies have not been compelled to disclose the identity of the person who has proposed the representation. However, the profit quality of the representation companies relied on the role of people involved in the representation. In the pre and post representation periods, this role might be significantly different.

Palmrose and Scholz (2004) argued that the compulsion for representation was determined by the company's management, auditor, or the Securities Exchange Commission (SEC). If auditors found distortion rather than management, the monitoring costs were expected to soar. The representations attributed to the third parties exhibited the incapability of management and internal controls to identify and correct critical distortions. In the case of such representations, users have been expected to doubt the reliability of financial information and to be more responsive to the market. Therefore, by acknowledging and rectifying important distortions, the executive managers would reflect their integrity, and restore confidence (Romanus, 2007). Bryan and Mason (2017), in a study on the executives' rewards and audit fees, investigated the relationship between the aforementioned variables using the panel data method. The results of their research revealed that the amount of rewards paid to the executives would increase the amount of audit fees demanded by the corporate auditors. Also, the results of their research suggested that with the improvement of the return on assets and the growth rate of cash flows and current ratio, the amount of corporate audit fees would rise. They also stated that the audit fees of companies dropped with an increase in the company risk.

On the other hand, a slight difference between the payment of senior executives and the board of directors would undermine incentives. Thus, increasing the payment difference would tempt executives to manipulate the earnings (Shi *et al.*, 2017).

The incentives for the oriented representation of financial statements can be divided into three categories. The first category contains the motivation of companies that struggle with the problem of low profitability and liquidity. These companies tend to improve their financial results by taking fraudulent actions and committing intentional mistakes. Conrads *et al.* (2014) investigated the criteria for rewarding executives, suggesting that if there were diverse criteria for measuring the amount of rewards paid to managers, the efficiency and performance of corporate executives would be enhanced. Heydari and Ranjbari (2015) studied the effect of the board's remuneration on the profit prediction using the financial information of 75 companies listed on Tehran Stock Exchange. This research exhibited that there was a significant and negative relationship between the board's remuneration and the next year's profits of the company. It also revealed that the current year's profit and remuneration of the board of directors were significant predictors of future earnings.

The second category embraces the motivations of companies that are willing to meet market predictions and expectations by resorting to fraud and committing deliberate mistakes. Billings



*et al.* (2014) explored auditors' rewards, audit fees and the quality of auditing. The results of their research illustrated that increasing the remuneration of managers raised the corporate audit fees. In the long run, this would increase the value of companies. The results of their study also suggested that increasing the number of independent members in the board of directors improved the managers' motivation for efficiency.

Sajadi and Zarezadeh Mehrizy (2012) investigated the relationship between directors' remuneration schemes and the economic performance evaluation criteria in companies listed on Tehran Stock Exchange. They declared that managers' remuneration was correlated with the economic performance criteria (economic value added, market, value added and adjusted economic value added). Also, the findings revealed that the market value added and the ownership of stock market were not significantly related to the other economic criteria of performance evaluation.

The third group embraces the incentives behind some contracts. Reward contracts based on the stock value and company performance have been examples of these contracts (Palmrose and Scholz, 2004).

Kirsten and du Toit (2018) investigated the relationship between the remuneration and financial performance for companies listed on the Johannesburg Stock Exchange. They reported that the remuneration mechanisms of the board had a positive impact on the company performance; however, it was associated with several drawbacks such as the temptation of management and reinforcement of opportunistic behaviors to manipulate the earnings. Therefore, the board's remuneration leads to the representation of financial statements. Chen *et al.* (2015) asserted that increasing the directors' incentives for reward exerts a proportional effect on the fraud inhibition. Also, the results of their research revealed that increasing these types of functions would escalate the company risk. However, considering the above, the board of directors has been the most important factor in controlling and managing a company. It is also responsible for protecting the interests of shareholders, a role that originates from the representation theory, and constitutes one of the oldest functions of the board of directors in companies. Frauds and recent collapse of financial institutions have highlighted the importance of the board of directors and its role as the trustee of shareholders and the protector of their rights. The board of directors can improve the quality and reliability of financial reporting by curbing opportunistic and profit-seeking behaviors of managers. As a result, it can mitigate the representation of financial statements in the next years.

Investors rely on their audit quality as the main decision-making criterion. Depending on their stance on audit, they can decide about investment in some cases (Andreou *et al.*, 2016). The quality of financial reports affects the corporate risk and the number of audit years augments the company's value and the quality of corporate auditing (Chen *et al.*, 2015). Based on the theoretical framework, and considering that most of the companies listed on Tehran Stock Exchange represent their financial statements, this study attempted to review the executives' rewards and representation. Therefore, the primary research hypothesis was as follows:

*There is a negative and significant relationship between the representation of financial statements and the reward of executives.*



## METHODOLOGY

This was an applied research that adopted descriptive methods for data collection. Considering the purpose and subject of this study, its results can help executives, investors and analysts to make more informed decisions. In this research, data was gathered using a descriptive - correlational method and the document analysis (financial statements of the companies listed on the Stock Market). Since the purpose of the study was to examine the relationship between independent and dependent variables, a correlational method was adopted. Moreover, since this research drew on the past information, a post-event research method was adopted.

The study population consisted of all companies listed on Tehran Stock Exchange in the period of 2011 to 2017. The sample was selected using the purposive sampling method. At each stage, companies that did not meet the following criteria were excluded, and the remaining companies were included in the analysis:

- ✓ Companies must have been active during the study period.
- ✓ The sample did not include banks and financial institutions.
- ✓ The fiscal year of the company ended at the end of March.
- ✓ The company was able to provide all the required information.

Finally, 108 companies were selected for testing research hypothesis.

### *Research Model*

Based on the theoretical framework and review of literature, the multivariate regression model was selected. Accordingly, the following model was adopted for testing, and some modifications were made.

$$\begin{aligned}
 RES_{i,t} = & \alpha_0 + \alpha_1 Lngap_{i,t} + \alpha_2 LnVPSTD_{i,t} + \alpha_3 CONC_{i,t} \\
 & + \alpha_4 DUALITY_{i,t} + \alpha_5 MANSHARE + \alpha_6 ACCRUAL_{i,t} + \alpha_7 INDE_{i,t} \\
 & + \alpha_8 LnBDSIZE_{i,t} + \alpha_9 BIG4 + \alpha_{10} GROW + \alpha_{11} SIZE + \alpha_{12} ROA_{i,t} + \alpha_{13} LEV \\
 & + \varepsilon_{i,t}
 \end{aligned}$$

### *Dependent variable*

Representation of financial statements (RES): This was a virtual variable (1 for companies that represented their financial statements and 0 otherwise).

### *Independent variables*

(LNGAP): Logarithm of executives' remuneration in the company *i* in the year *t*

(LNVPSTD): Standard deviation of executives' remuneration in the company *i* in the year *t*

Control Variables

Board Duality: If the chief executive officer was the chairman or vice chairman of the board, this variable was set to 1; otherwise, it was 0.

Independence of the Board of Directors (INDE): The number of non-executive board members divided by the total number of board members

Board Size (BRDSIZE): Total number of the board members

Management Concentration (CONC): Percentage of shares owned by the major shareholders (i.e. shareholders that owned more than 5% of shares)

Management Ownership (MANSHARE): Percentage of shares owned by the board members





(ACCRUALS<sub>i, t</sub>) was the ratio of total accruals to total assets of the company *i* in the year *t*. The company's financial leverage was defined as the ratio of the total company's debt to its total assets (Lev).

Size of Company (Size): It was defined as the natural logarithm of the company's total assets.

Audit Type (BIG): As a dummy variable, it was set to 1 if the independent auditor for company was the Auditing Organization (Under the supervision of the Ministry of Economic Affairs and Finance of Iran); otherwise, it was set to zero.

Return on Assets (ROA): Ratio of net profits to the total assets

Sales Growth (Growth): Changes of the company sales

## DATA ANALYSIS

The results of descriptive statistics of the research variables have been shown in Table (1).

**Table 1: Descriptive statistics of model variables**

	Standard deviation	Min	Max	Mid	AV
RES	0.058	0.001	0.162	0.0051	0.006
LNGAP	0.254	1.001	3.851	2.015	2.147
LNPSTD	0.041	0.008	2.00	1.020	1.250
DUALITY	0.36	0	1	1	0.792
INDE	0.39	0.14	0.58	0.23	0.24
BRDSIZE	0.87	2.01	7.64	5.01	5.12
CONC	0.51	0.12	0.72	0.42	0.49
MANSHARE	0.63	0.09	0.52	0.17	0.18
ACC	0.08	0.11	0.54	0.14	0.21
BIG	0.87	0.00	1	1	0.24
LEV	0.61	0.11	0.91	0.59	0.64
ROA	0.39	0.12	0.74	0.19	0.22
GROTH	0.68	0.567	2.361	1.480	1.520
SIZE	0.32	5.748	18.960	14.016	14.452

On average, 0.65% of the assets in studied companies were provided through debt financing. Therefore, according to the descriptive statistics of research variables, it could be stated that all variables were properly distributed.

### *Inferential statistics*

As mentioned earlier, the purpose of this research was to investigate the relationship between the financial incentives of executives and the representation of financial statements in companies listed on Tehran Stock Exchange. Therefore, a model consisting of a series of independent and control variables was developed and examined based on the theoretical foundations.

### *Investigating Linear Regression Hypotheses*

#### *The variance of residuals was fixed.*

According to one of the linear regression hypotheses, all residuals have identical variance. In practice, however, this hypothesis may not hold true, as there may be variance heterogeneity due to the factors such as the falseness of the model function, the presence of discrete points, and the structural failure in the statistical population. For these reasons, economists have introduced various tests to address this problem. In this study, the equivalence of residuals variance was evaluated using the White's test. The results rejected the null hypothesis regarding the existence of a variance equivalence, as shown in Table (2). In other words, it could be argued that there was a variance heterogeneity in the research model. Therefore, to eliminate the variance heterogeneity in the model, the generalized least squares (GLS) regression was employed.

**Table 2: The results of the fixed error variance test**

	Prob	F	Result
Model	0.0000	4.619	There is a variance heterogeneity

#### *Lack of auto-correlation of residuals*

According to the hypothesis of the classic linear regression model, there was no correlation between the remaining regressions. The Breusch–Godfrey serial correlation LM test was used to investigate the independence of residuals. In this test, the null hypothesis indicated the lack of self-correlation, while the opposite hypothesis denoted the existence of a serial self-correlation between errors. Given that the probability of F statistics in the model was higher than 5% at a confidence interval of 95%, the null hypothesis was confirmed by the test results. Therefore, the lack of self-correlation between residuals was not rejected. That is, the research model contained an assumption regarding the absence of self-correlation for the error component. Table 3 shows the results of testing the absence of auto-correlation of residuals.

**Table 3: Testing the lack of auto-correlation of residuals**

	Prob.	F	Result
Model	0.7102	0.1422	Lack of auto-correlation

#### *Reliability Analysis of Variables*

The reliability of research variables was evaluated in this section. For this purpose, the Dickey Fuller test was used. The results of this test have been shown in Table (4). If the calculated value was smaller than the table statistics, the null hypothesis would be rejected, and the assumption regarding the existence of a single root would be confirmed. According to the results of the reliability test, since the p-value for all variables was less than 0.05, the reliability of research variables was confirmed. Moreover, it suggested that variables were durable throughout the research period.

**Table 4: Unit Root Test**

Variable	LLC		Result
	Prob.	Statistic	
RES	0.0000	-12.526	Stationarity



LNGAP	0.0000	-18.203	Stationarity
LNVPSTD	0.0000	-69.015	Stationarity
DUALITY	0.0000	-25.360	Stationarity
INDE	0.0000	-.19.665	Stationarity
BRDSIZE	0.0000	-32.98	Stationarity
CONC	0.0000	-69.00	Stationarity
MANSHARE	0.0000	-12.05	Stationarity
ACC	0.0000	-16.55	Stationarity
BIG	0.0000	-26.130	Stationarity
LEV	0.0000	-19.67	Stationarity
ROA	0.0000	-36.20	Stationarity
GROTH	0.0000	-24.19	Stationarity
SIZE	0.0000	-14.52	Stationarity

### Normal Distribution of Residuals

One of the key assumptions in residuals has been the normal distribution of sentences. To test the normalized residual statement, the Jarque-Bera test statistic was used. According to the results, since the probability of the Jarque-Bera test statistic in the research model was greater than 5%, the normalized error assumed in the null hypothesis was confirmed. That is, the assumption of the normalized error in the research model was approved.

**Table 5: The normality tests of residuals**

Hypothesis	Jarque-Bera statistic	Prob	Result
Regression model	58.21	0.0582	Normalized Residual

### F-Limer and Hausman test

Prior to the model estimation, it is necessary to utilize the F -Limmer test to examine the panel data method with the constant effects and to draw a comparison with the combined data method in the above model. The hypotheses of this test were as follows:

$H_0$ : Normal Combined Data

$H_1$ : Panel data with fixed effects

The results of F-Limer test have been shown in Table (6).

**Table 6: the results of F-Limer test**

Prob	Static	Result
0.0000	2.011	Panel data

As shown in Table (6), the results rejected  $H_0$ . Hence, the model with panel data and constant effects was preferred.

Hence, it was essential to use Hausman test to choose a panel data method with either fixed or random effects.

**Table 7: The results of Hausman test**

Prob.	Static	Result
0.0101	12.052	Panel Data with Fixed Effect



According to the results depicted in Table (7),  $H_0$  was rejected. Therefore, the model with panel data and constant effects was preferable.

Now, the results of research pattern estimation in Table (8) have been illustrated using the panel data method with constant effects. Finally, to test hypotheses in the regression model with constant effects, the authors investigated the generalized least squares method for the dependent variable (representation of financial statements), along with the independent (the board's rewards) and control variables.

According to the results of Table (8), the calculated F-statistic (51.041) and its error (0.00), it could be posited that the research model was significant at a confidence interval of 99%. Also, according to the adjusted coefficient of determination obtained for the model (67%), the independent and control variables explained more than 65% of variation in the dependent variable. In addition, according to the Durbin–Watson statistic (1.798), there was no first-step autocorrelation between the model's residuals.

**Table 8: The results of research model estimation**

	Prob.	T Statistics	Std. Error	Coefficient
LNGAP	0/0000	5/0832	0/0497	<b>0/2525</b>
LNVPSTD	0/0000	5/0472	0/0030	<b>0/0153</b>
DUALITY	0/0000	4/8140	0/1733	<b>0/8344</b>
INDE	0/0000	-16/8953	0/0005	<b>-0/0088</b>
BRDSIZE	0/0150	-2/4388	0/0102	<b>-0/0249</b>
CONC	0/0000	-5/1403	0/0082	<b>-0/0424</b>
MANSHARE	0/9482	-0/0649	0/0018	<b>-0/0001</b>
ACC	0/9099	-0/1133	0/0929	<b>-0/0105</b>
BIG	0/0000	11/7616	0/0706	<b>0/8304</b>
LEV	0/8296	-0/2153	0/3935	<b>-0/0847</b>
ROA	0/0364	-2/0960	0/2181	<b>-0/4571</b>
GROTH	0/0000	5/9575	0/3773	<b>2/2476</b>
SIZE	0/4565	0/7450	0/0171	<b>0/0127</b>
C	0/0000	17/9301	0/9869	<b>17/6952</b>
F-statistic (P-Value)	<b>(51.041) 0.000</b>			
R- Squared	0.67			
Adjusted R- Squared	0.65			
Durbin – Watson Stat.	1.798			



According to the results, the variable coefficient of the board's remuneration was 0.2525, which indicated its positive effect on the representation of financial statements. According to the t-test statistic, the variable coefficient of the board's remuneration was significant at a confidence interval of 95%. Hence, the research hypothesis was confirmed at a confidence interval of 95%, which reflected a positive relationship between the board's remuneration and representation of the financial statements. Also, the variable coefficient of board duality was 0.8344, which mirrored its positive effect on the representation of financial statements. The results of t-test statistic suggested that the variable coefficient of the board duality was significant at a confidence interval of 95%. Thus, the research hypothesis was confirmed at a confidence level of 95%, exhibiting the positive relationship between the board duality and the representation of financial statements.

The variables of the board independence, the board size and the concentration of ownership were inversely related to the representation of financial statements in terms of the level of significance and the coefficient of estimation.

## CONCLUSION AND SUGGESTIONS

The profuse accounts of scandals over the last few years have undermined the public trust in corporations and their audit institutions. All these scandals have been associated with the representation of financial statements. In most cases, the representation of financial statements has been indicative of problems in the internal control and management system of companies whose reputation and value have been damaged in the market, or are on the verge of bankruptcy (Biyabani and Kazemi, 2013). Therefore, considering the role of corporate governance mechanisms in aligning the interests of managers and shareholders and enhancing the reliability of financial information, it was expected that the elevated quality of corporate governance improved the quality of financial reporting, and reduced the representation of financial statements. Therefore, this study was conducted to explore the relationship between financial incentives of executives and the representation of financial statements.

The results of hypothesis testing exhibited that there was a positive and significant relationship between the board of directors' remuneration and the representation of financial statements. The higher remuneration of directors was associated with the greater possibility of the renewed profit delivery. Also the probability of the representation of financial statements was higher in companies that had restrictions in debt contracts, had increased their capital, and had a single person as the CEO and the head of the board of directors. Tempted to achieve higher rewards, managers sought to manipulate the earnings, which in turn increased the probability of the representation of financial statements. The results were consistent with those reported by Kirsten and du Toit (2018). Therefore, it is recommended that legislators pay greater attentions to the representation of financial statements and its control mechanism by establishing specific terms and conditions, and limiting the possibility of exploitations. Investors and shareholders should also focus on the representation of financial statements, especially when it is constantly repeated by companies. The audit organization, as a legislative and governmental administration, must present a model for increasing audit quality in an attempt to reduce the incorrect information offered by companies to their users. It consequently would lead to the representation of financial statements.



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