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HOW CORPORATE GOVERNANCE INFLUENCES INVESTMENT DECISIONS VIA AUDIT EFFECTIVENESS: INSIGHTS FROM PAKISTANI FIRMS

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ABSTRACT

This study examined the non-financial firms listed on PSX Pakistan Stock exchange from 2013 to 2023 to see impact of corporate governance (CG) on investment efficiency, highlight the intermediary or mediating role of the financial quality reporting. Markets in emerging states like Pakistan, the strong corporate governance is vital for the reduction of agency problems, aligning managerial function and actions with shareholder's objectives and encourage of growth with long lasting and steady effect of growth. The study contains the generalized method of moments tactics to control issues like factors that are hidden and relationships in which results affected. Moreover, it develops a corporate governance index with a method called principal component analysis. This index provides a simple way to measure different aspects of a system of entity governance. The expected finding highlights that strong corporate governance (CG) enhances improvement of financial reporting quality, which positively influences the information efficiency (IE). This research has addition to literature by explanation on how corporate governance & reporting quality work together to improve investment results. It also offers practical insights for corporate managerial, investors, auditors, and policymakers in Pakistan development on business environment.

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INTRODUCTION

The investment of business plays pivotal role in assessing the firm's value and addresses a long-term standing issue in corporate financial literature (Aburasul, Anas, Hasan & Rahman, 2024). While theoretically guidance on investment opportunities and corporate investment decisions tells the friction on various markets, like agency conflicts and information asymmetry, often cause firms to diverge from best investment behavior (Jensen, 1986; Shleifer & Vishny, 1997). These ineptitudes typically show in two forms: underinvestment, in which financially constrained firms are not able to pursue positive net present value projects, and overinvestment, where firms deal capital to projects with negative NPV (Berkovitch & Kim, 1990; Liu, Li, Zhang & Wang, 2022). The research (Biddle & Hilary, 2006; Biddle, Hilary & Verdi, 2009; Boubaker, Chourou & Saffar, 2018; Houcine, 2017; Houcine, Ali & Omri, 2022; Stein, 2003) plays up that high-quality financial reporting boosts investment efficiency by reduces these frictions. A strong information framework helps minimize excessive and insufficient investment by increasing the transparency, strengthening accountability, and enabling the precise allocation of capital (Hsu, Huang, & Huynh, 2023; Nguyen, Ngo, Huynh, Quoc & Hoang, 2022).

The researchers explored in context of Pakistani firms, the relationship amid corporate governance structures and investment efficiency, with a specific focus on the intermediary role of audit quality (Ali, Javaid, Tharwani, Ali & Saher, 2020; Ali, Ali, Khan & Ghulam, 2020; Xu, Bakar & Ali, 2019). The credibility has given special attention and clarity of financial reports, which serve as crucial instruments for effective decision making. This study aims to explore interplay between effective corporate governance and transparent financial reporting in shaping investment decisions. In today fast-changing business world, the relationship between company leaders and shareholders is a key to long-term success (Khan & Haq, 2025; Haq & Khan, 2024). However, these two groups often have different goals, which can hurt the company's performance (Shah, Qamar, Ahmed & Imran, 2025; Haq, Malik, Ullah & Shah, 2024; Noor, Khan, Irfan & Shah, 2024). The good corporate governance helps solve these problems by making companies more transparent and accountable. The idea of corporate governance started with Berle and Means (1932), who studied how, company owners (shareholders) and the managers have different roles (Nadeem, Khan & Atta, 2024; Khan, Farooq & Kamal, 2023).

Later, Jensen and Meckling (1976) explained this relationship in detail, showing that how managers might sometimes act in their own interests instead of what's best for the shareholders. The important theories like stakeholder theory, stewardship theory, and signaling theory also helps in explaining how corporate governance works. Together, these ideas show why companies need strong systems and regulations to make sure managers act to their best interests of involvement of everyone not just shareholders, but also employees, customers, and society. The good corporate governance ensures companies operating in fairly, openly, and responsibly, which builds trust with investors, workers, and regulators. The study of Akingunola (2013 has found that when companies follow the strong governance practices, they make smarter investment decisions and perform better financially. The investment represents the careful allocation of company's resources to generate sustainable growth. The perception of investment efficiency examines how well organizations use their capital, helping them steer clear of two common mistakes: missing out on worthwhile projects (underinvestment) or wasting funds upon unprofitable ventures (overinvestment) (Li & Wang, 2010; Islami, 2017; Siregar & Nuryanah, 2019).

A significant challenge in realizing optimal investment efficacy stems from information asymmetry, situations where company executives possess detailed knowledge than shareholders, potentially leading to decisions that benefit managers rather than the organization (Verdi, 2006). Professional audits play a crucial role in the corporate finance by ensuring financial reports are accurate and trustworthy. Thorough audit examinations help balance the information gap between a company's management and its investors, allowing for further informed capital allocation choices (Mandal, 2023). Reliable financial statements prepared in accordance with generally accepted accounting principles present the real performance of an entity (Rashid, 2020; Hasan, Hossain & Habib, 2022). This study focuses on relationship between financial reporting quality and governance practices that affect investment efficiency. The results show that better corporate governance leads to better investment outcomes through improved quality of the financial reporting. In particular, the most powerful relationship between reporting and investment effectiveness in the companies with well-established governance framework conditions (Houcine, 2017; Houcine, Ali & Omri, 2022; Javed, Malik & Rizwan, 2023).

LITERATURE REVIEW

Armstrong, Guay and Weber (2010), Jensen and Meckling (1976) and Larcker and Tayan (2020) found in their research that good corporate government plays a role in the direction of shareholders' interests and profits, and makes better investment decisions. Meanwhile, Stein (2003) argued that strong governance increases transparency, reduces conflicts between different interest groups, and improves resource allocation by companies (Feng, Rana, Bashir, Sarmad, Rasheed & Ayub, 2023; Hafeez, Rana, Khan, Ahmad & Rehman, 2011). The corporate governance (CG) practices have a recognized connection with the valuation of firms listed on Pakistan Stock Exchange (PSX). A key aspect under discussion is relationship between governance, firm size, and financial performance. Scholars across finance, economics, strategic management, and marketing have long investigated what factors drive corporate profitability (Ahmad, Qureshi, Bilal & Rana, 2021). Among these, firm size is frequently highlighted as a critical determinant influencing a company's operations and external interaction. Larger firms shape competitive environment pointedly due to their substantial market share and cost efficiencies, giving them a competitive advantage over smaller firms. With greater access to resources, these firms can allocate investments more strategically into high-return ventures (AlGhusin, 2015).

Bhatt and Bhatt see at how the Malaysian code of corporate administration influenced 113 freely exchanged companies in Malaysia. The self-improvement CG record is utilized to degree quality of corporate administration. The investigate appears that there is a solid connection between great corporate administration and budgetary victory. When MCCG 2012 was compared to MCCG 2007, an enormous improvement was seen within the quality of administration. The CG file was made by Arora and Bodhanwala (2018). They utilized information from Indian showcase around corporate administration, possession, competition and control. This report looked 407 companies as exchanged on the Bombay Stock Trade from 2009 to 2014. Utilizing the arbitrary impact approach as a way to assess, the ponder finds a factually critical interface between the Corporate Administration Record (CGI) and commerce execution. Al-Sartawi and Sanad (2019) see at the organization possession of Bahraini businesses to discover out what impact it has on the victory of the trade. Analysts did a multivariate ponder to discover out on the off chance that organization proprietorship of a company was connected to more cash coming in for company. By and large, level of administration within the test associations is low.

This implies that government ought to take steps required to create great corporate administration more of a need in businesses. By and large, the information appears that the two are connected in a terrible way. A few Pakistani thinks to have looked at how diverse sorts of administration influence the esteem of a commerce, but exceptionally few have attempted to discover a connect between corporate administration and budgetary execution by making an administration file. Sheikh, Wang and Khan (2013) see into the impact that inner administration parameters have on the benefits of Pakistani businesses. In this ponder, numbers for 154 non-financial companies from 2004 to 2008 were looked into. Bookkeeping return (ROA), return on value (ROE), profit per share (EPS), and the advertise the book proportion have all been utilized to figure out how productive the company is. Estimate and leverage of a firm are utilized as comparison focuses. When possession is consolidated, distinctive things happen. There's a negative interface between insider proprietorship and chiefs from the exterior, and when more chiefs are on the board, the team's athletic execution goes up. The comes about back up the hypothesis of the entrenchment impact, which says that insider possession therefore harms the business's execution since the insiders put their claim needs ahead of those of individuals from exterior.

This counterargument backs up organization speculation by appearing that rising administration shareholdings are here to remain. It makes the difference as enormous shareholder but harms little shareholders, and it makes it simpler for supervisors and principals to battle with each other. Strong corporate governance supports this process through comprehensive monitoring systems that keep management accountable while strengthening audit credibility (Danish, Akhtar & Imran, 2025; Mankash, Ahmed, Shabbir & Imran, 2025; Hafeez, Yaseen & Imran, 2019). Still, the governance which is weak can result in the financial irregularities, poor operational decision makings, or even fraudulent behavior which negatively affect a firm's investment capabilities and market reputation (Karim, Lee & Suh, 2018; Mandal, 2023). Makki and Lodhi (2014) investigate looks at the connect between CG, the foot line of the company, and the esteem of its mental capital. As they had trusted, they discover that CG has no impact on how well the company does. A great administration system, on the other hand, makes a company's mental capital more profitable. Nazirand (2018) see into how the connect between corporate governance and trade esteem is influenced by the benefits that are up to the administration.

For this investigation, the record of administration was made utilizing information from 29 different governance approaches at the test associations. ROI, EV, and ROA all appear how monetarily solid a company is. From 2004 to 2016, information from 160 companies was collected. This ponder appears that the CG file is connected to all measures of company benefit in a positive way. A company will make more cash in the case its administration list is better. Bhat, Chen, Jebran and Bhutto (2018) looked at both state-owned and private businesses in Pakistan to discover out how CG variables influenced how well the businesses did. Board committee characteristics are utilized to degree the quality of administration at test companies, whereas Tobin's Q is utilized to degree the execution of the companies, with advertise cap and ROA as control factors. Utilizing board information methods, we discover that, with the special case of board freedom, which incorporates the significant positive relationship with the firm's esteem within the case of state-owned undertakings, administration factors have no noteworthy relationship with firm performance in both state-owned and privately-owned businesses. Thus, the moment finding shows that the positive relationship between return on the resources and showcase capitalization features the huge impact on the esteem of a company no matter how it is possessed.

This consider looks at the long time 2007 through 2011. Utilizing seven CG factors, an administration record is made to degree the quality of administration in the microfinance educates. This record is at that point utilized to discover the joins between administration quality and company execution. There isn't much of an interface between CG and trade esteem at microfinancing educate in Asia. Governance standards include shareholder protection, independent regulations, proper auditing, and institutional investors' participation in ensuring that companies can use more well-organized companies (Chen & Lin, 2012). These practices promote correct financial reporting, disagreement between managers and owners, a higher level of transparency, and lead to improved investment decisions (Kanagaretnam et al., 2007). This especially happens when managers pursue the personal benefits without proper reviews (Garcãa., 2020). Interestingly, some studies have shown that good governments can help rally investment decisions, regardless of whether companies invest too much or too little (Biddle et al., 2009). Institutional investors such as pension funds, investment funds, and insurance companies have well access to information and monitoring skills compared to individuals or founding shareholders.

By influencing the strategic decisions, selecting board members, and securing profits for minority stakes as supervisory functions help to curb agency problems (Enriques et al., 2017). Through active participation and voting rights, the institutional shareholders ensure management responsibilities, while simultaneously promoting both company performance and investment efficiency (Larcker & Tayan, 2020). The research demonstrates that companies with robust governance systems including well-structured boards, effective ownership controls, and rigorous audit oversight tend to make the superior investment decisions that enhance shareholder returns (Agyei-Mensah, 2021; Tawfik et al., 2022). Empirical work by Okaro and Okafor (2015), Anafiah et al. (2017), and Suryanto et al. (2017) confirms that the specific governance mechanisms like board diligence, audit committees, major shareholder oversight, strengthen audit quality (AQ), thereby improving financial transparency. However, the relationship between governance and AQ shows the regional variations. While some studies document the strong positive association (Haque et al., 2019; Sailendra et al., 2020), others reveal inconsistent results particularly regarding managerial ownership and board independence, which sometimes show negligible effects on AQ (Soliman & Abd Elsalam, 2012; Dwekat et al., 2018; Kasim et al., 2016).

RESEARCH METHODOLOGY

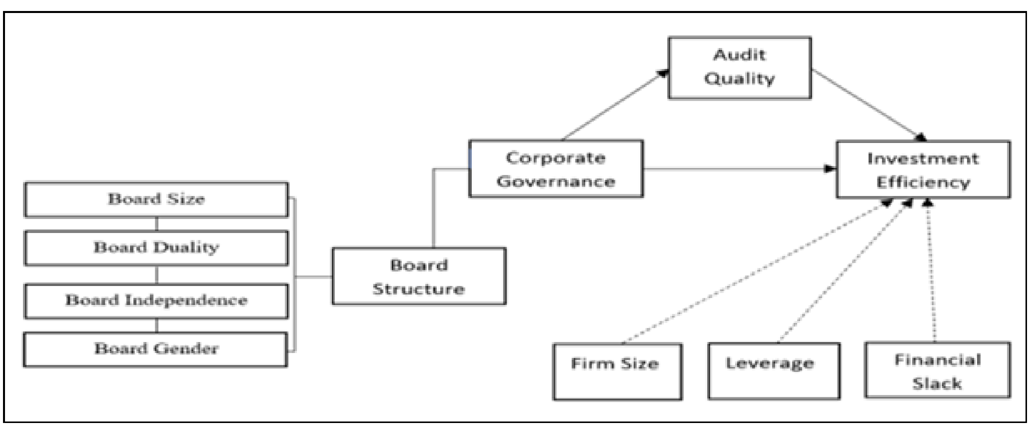
The structure of the current study influences core management theory and understands how firm governance is related to testing practices and investment decisions. This study examines the natural conflict between the company owners as well as managers, primarily using agent theory (Jensen & Meckling, 1976). This theory explains that how problems arise when the managers' goals distinguish from the highest goals for the shareholders. An effective governance system will help resolve these disputes by ensuring that manager decisions are consistent with owner's interests and lead to better investment decisions.

Table 1 Scope of Study

Component	Details
Population	Firms listed on the Pakistan Stock Exchange (PSX)
Sample Size	200 non-financial firms
Sampling Technique	Convenience Sampling
Study Period	2013 to 2023
Research Objective	To investigate the mediating role of (AQ) between (CG) and (IE)
Estimation Technique	Generalized Method of Moments (GMM)
Analytical Model	Structural Equation Modeling (SEM)
Key Variables	Corporate Governance (CG), (AQ), Investment Efficiency (IE)
Scope of Study	Focused upon non-financial sector firms in Pakistan capital market context

Research uses some important theories to better understand topics. First, Signaling Theory (Spence, 1973) show how good corporate management and thorough audits send positive news to investors. Second, the stewardship theory (Davis et al., 1997) shows that if company has a strong management system, managers are likely to make decisions that will benefit the entire company. Many studies have shown that good audits link strong corporate management with better investment decisions (Ali et al., 2019; Francis et al., 1999; Javed & Qazi, 2023). If they are well-managed, companies are undergoing better audits that help them use their money wisely, as their financial reporting is more honest and clearer.

Figure 1 Comprehensive Structure



DISSCUSIONS

This study examines that how corporate governance affects investment decisions in Pakistan's non-financial sector, with particular attention to the roles of financial reporting and auditing quality. Using data from companies listed on the Pakistan Stock Exchange over ten years, we developed a more complete picture than previous studies by looking at both direct and indirect relationships between these factors. Our approach stands out in some ways. First, we used sophisticated statistical methods (GMM and 2SLS regression) to ensure our results are not distorted by the common research problems. Second, by studying many companies over the long period, we've produced findings that are both reliable and relevant to real business conditions. Third, our innovative dual mediation model recognizes that financial reporting and audit quality work together to connect governance practices with investment outcomes. In this connection, the verified financial information from the external auditors serves as a crucial mechanism for upgrading the capital allocation effectiveness (DeFond & Zhang, 2014). When company inside numbers finally match up with what shareholders read on the street, markets breathe the little easier. A solid audit turns those figures into something investors can confidence; a shoddy one just invites doubt (Francis, Maydew & Sparks, 1999; Javed, Malik & Rizwan, 2023).

Hard-nosed corporate governance-boards that ask the tough questions, clean leadership lines, and ownership that is not all parked in one family-tilts decision-making towards sanity. The healthier governance tends to nudge auditors toward same high ground (Ali, Salleh & Hassan, 2019; Khan, Ismail & Khan, 2019; Iqbal, Nawaz & Ehsan, 2021). In places like Pakistan, where business customs can wander far from playbooks of developed markets, watching that crossroad between oversight and audit quality may be clearest way to gauge how stable future investments will be. The research design carefully tests our hypotheses using multiple approaches, examining everything from board structures to ownership patterns. This thoroughness gives us confidence in our conclusions while making the findings useful for both academics and business professionals. For Pakistan's developing economy, our results provide valuable insights about how better governance leads towards smarter investments over improved financial transparency and oversight. Ultimately, this study advances our understanding of corporate decision-making by showing how different governance elements interact in practice. In this linking, the findings of research should help the Pakistani companies strengthen their operations while offering the regulators evidence-based guidance for improving the business standards.

CONCLUSION

This study focuses on how corporate governance practices influence the investment decisions in the Pakistan business setting and 200 non-financial companies listed on the Pakistan Stock Exchange between 2013 and 2023. Careful analysis using advanced statistical methods has been found that well-built the corporate governance improves both test quality and financial report quality. These improvements allow businesses to make the intelligent investment decisions. Our results show that good governance appears to be chain reaction. If a company has strong monitoring mechanism, it can essentially provide more reliable financial information, identify and pursue the most promising investment chances, while avoiding wasted expenses. For Pakistani companies looking to improve performance, our results show that some advantages can be achieved by strengthening corporate management across the organization. The data shows an interesting pattern in research by Pakistani companies. We found that the investment efficiencies (i.e.) and quality of financial reporting (FRQ) of various companies differ considerably. It is important to ensure that our statistical checks show no problematic overlap amid factors measured, and that results are reliable. Our analysis confirmed four key findings:

- ✓ Better corporate governance leads to higher quality audits (H1)
- ✓ Superior audits result in more efficient investments (H2)
- ✓ Strong governance directly improves investment decisions (H3)
- ✓ Audits serve as a crucial link between governance and investment quality (H4)

These results have important practical effects on Pakistan business world, show how implementing strong governance practices and maintaining strict financial reporting can help businesses make more smart investment decisions. This is particularly valuable in Pakistan developing economic environment, and by using resources efficiently, it can make the difference between success and failure for company. The results provide concrete evidence to company managers and supervisory authorities who want to strengthen the company sector in Pakistan through the improved oversight and transparency.

Future Direction

The limitations of this survey are intended for non-financial companies listed on the Pakistan Stock Exchange from 2012 to 2023, so results are likely not generalized to financial institutions or other contexts. Several aspects of corporate governance (CG), (IE), and (FRQ) may not be fully installed due to limitations. The use of secondary data and convenience cabbies can introduce distortions and do not take into account fixed properties or endogenous concerns. Future research could expand the sample to include financial firms and explore other developing economies for comparative insights. In this regard, using more recent or longitudinal data and addressing endogeneity with advanced methods may offer deeper sympathetic of evolving relationship amid corporate governance, audit quality (AQ), and IE.

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