

The Effects of Political Instability on Financial Restatement in Libyan Banks: Evidence from External Auditors

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تأثيرات عدم الاستقرار السياسي على إعادة عرض القوائم المالية في المصارف الليبية:
أدلة من وجهة نظر المراجعين الخارجيين

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Received: October 28, 2025

Accepted: December 29, 2025

Published: January 06, 2026

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Abstract:

This study attempts to investigate the impact of political instability on financial restatement in Libyan banks from external auditors' perspective. It focuses on the attitudes of external auditors as they play an important role in verifying the reliability of financial reports in the middle of politically unstable economic conditions. Data has been collected using 74 structured questionnaires that were distributed among external auditors working in the capital of Tripoli, Libya. Through using quantitative analysis, the research has examined the potential effects of political instability on the occurrence of financial misstatements and the subsequent financial restatements. Results indicate that political instability can significantly affect the quality of financial reports, largely through weakening institutional oversight mechanisms and compromising the independence of external auditors. these findings implies that unstable political conditions increase the risk of financial restatement by banks through the created ambiguity in standard compliance level and banks' governance structures.

Keywords: Political instability, external auditors, financial restatement, Libyan banks, audit quality.

المخلص:

تهدف هذه الدراسة إلى بحث أثر عدم الاستقرار السياسي على إعادة عرض القوائم المالية في المصارف الليبية من وجهة نظر المراجعين الخارجيين. وتركز الدراسة على وجهات نظر المراجعين الخارجيين نظراً لدورهم المحوري في التحقق من موثوقية التقارير المالية في ظل ظروف اقتصادية تتسم بعدم الاستقرار السياسي. وقد جُمعت البيانات باستخدام 74 استبانة مُنظمة وُرعت على مراجعين خارجيين يعملون في العاصمة طرابلس، ليبيا. ومن خلال استخدام التحليل الكمي، فحصت الدراسة الآثار المحتملة لعدم الاستقرار السياسي على حدوث الأخطاء والتعريفات الجوهرية في القوائم المالية وما يترتب عليها من إعادة عرض لهذه القوائم. وتشير النتائج إلى أن عدم الاستقرار السياسي يمكن أن يؤثر بشكل معنوي على جودة التقارير المالية، وذلك إلى حد كبير من خلال إضعاف آليات الرقابة المؤسسية والمساس باستقلالية المراجعين الخارجيين. وتقيد هذه النتائج بأن الظروف السياسية غير المستقرة تزيد من مخاطر إعادة عرض القوائم المالية في المصارف، نتيجة الغموض الذي تخلقه فيما يتعلق بمستوى الالتزام بالمعايير وهياكل الحوكمة المصرفية.

الكلمات المفتاحية: عدم الاستقرار السياسي، المراجعون الخارجيون، إعادة عرض القوائم المالية، المصارف الليبية، جودة المراجعة.

Introduction:

Financial restatements is regarded as one of the crucial critical indicators of weaknesses in the quality of financial reporting and accounting systems, it often reflects mistakes or errors, irregularities, and deliberate misstatements that deteriorate stakeholders' confidence in the organization (Hennes, Leone, & Miller, 2008). In politically stable economic conditions, financial restatement is typically credited to changes in accounting methods or standards, or other normal accounting errors. Nevertheless, in the existence of political instability, this is not often the case. According to Aljaaidi, Bagudo, and Abdulrahman, (2021) the causes often go beyond these technical accounting matters to include failures in institutional and governance structures and audit failure. Additionally, political instability disturbs the work of financial regulation mechanisms, weakens corporate governance mechanisms, and impairs auditors' independence to verify standards compliance, thus increasing the chance of financial restatement occurrence (Agyei-Mensah, 2019).

Libya has witnessed a persistent political division since 2011, which has introduced challenging conditions for local banks and other financial institutions. Political division can be seen in rival governments, deteriorated legal systems, and fragmented regulatory authorities. According to Elamer, Ntim, and Abdou (2020) this state has damaged largely the financial reports' credibility and transparency of almost all the banks. In fact, Libyan banks, as the mainstay of the economy, work in unpredictable conditions that diminish both managerial accountability and audit trustworthiness. Subsequently, external auditors encounter problems in reaching sufficient solid audit evidence, utilizing consistent standards of audit, and verifying financial reports accuracy. These conditions of political instability lead to higher risks of financial restatements.

In spite of the key role played by external auditors in ensuring the integrity of financial reports, there is a little empirical research that have investigated the impact of political instability on the occurrence of financial restatement in post-civil war economies. For example, many studies were made either in developed or politically stable nations (e.g., Palmrose, Richardson, & Scholz, 2004; Hennes et al., 2008), which left a substantial gap in the literature regarding how political disturbances outline auditing and reporting practices and outcomes in politically divided regions. Although the institutional and governance structures in Libya are fragile and the enforcement mechanisms are weak and inconsistent, the influence of political instability on financial restatement is still largely uninvestigated.

According to World Bank (2023), the condition of political instability in Libya resulted in several changes in financial reporting regulations, fragmented role of oversight between the Central Bank of Libya and the rival governments, and interruptions in the financial information flow. Such problems do not only diminish the governance systems of banks but also decrease auditors' capacity to execute their duties successfully. It is argued by Al-Janadi and Rahman, (2016) that since external auditors' main duty to evaluate compliance and detect material misstatements, their professional judgment can be vulnerable to institutional uncertainty and political pressure. Thus, external auditors could find themselves in greater challenge to ensure financial reports' transparency and credibility, which leads to higher risks of financial restatements.

Given these conditions, this research is set to explore the relationship between political instability and financial restatement in Libyan banks from the perspective of external auditors working in the city of Tripoli, Libya. The current study also aims to identify certain ways or mechanisms by which political instability participates in financial restatements.

Literature Review:

Political Instability and the Financial Reporting :

Political instability is explained as the frequent government changes, armed war, policy uncertainty, or the institutional discontinuity which deteriorates the work of formal governance mechanisms (Aisen & Veiga, 2013). In politically unstable countries, regulatory bodies tend to face several challenges such as, interruptions, laws and regulations being enforced inconsistently, and stakeholders' trust including investors' trust weakens (Ali & Al-Attar, 2022). Elamer, Ntim, and Abdou (2020) argued that this type of political instability worsens corporate governance mechanisms and accounting standards enforcement, which in turn creates an environment suitable for fraud, manipulation, and low financial reporting quality. In the context of banking industry, the political instability is predominantly destructive as these institutions rely on central bank coordination, regulatory credibility, and timely supervision (World Bank, 2023). When those mechanisms do not work in harmony and simultaneously, as in Libya's divided financial system, the practices of financial reporting become inconsistent across these banks. Agyei-Mensah (2019) indicated that in politically divided countries, managements might exploit the resultant gaps in the regulatory system to report optimistic financial results such as, escaping from loss recognition or hiding information related to the real position of business liquidity. Therefore, the likelihood of financial restatement in politically fragmented markets becomes higher.

Financial Restatement as A Sign of Reporting Weakness:

Financial restatement happens if a company revises and corrects material misstatements in already issued financial reports as a result of either fraud or errors (Hennes, Leone, & Miller, 2008). According to Palmrose, Richardson, and Scholz (2004), financial restatement has a negative influence on market confidence, which sends signals of failures in governance structures including internal control systems and external audit function. Additionally, empirical evidence indicates that the frequency of financial restatements is linked to poor monitoring and control mechanisms, insufficient enforcement of regulations, and lack of auditor independence (Chen, Hribar, & Melessa, 2018).

Financial restatement in stable authorities generally occurs due to issues related to technical accounting procedures or voluntary corrections (Files, Swanson, & Tebo, 2009). However, financial restatement in unstable conditions is an indicator of deficiency in governance systems (Aljaaidi, Bagudo, & Abdulrahman, 2021). In addition to that, Political uncertainty intensifies the consequences of those deficiencies in the governance systems by weakening institutional oversight and lessening the deterrence role of law and external audit.

Political Instability and External Audit Quality:

External audit quality is influenced by many factors such as auditor's competence, independence, institutional and legal enforcement, corporate governance structures (DeFond & Zhang, 2014). However, Political instability may lessen every support by these factors. For example, government frequent changes can lead to frequent adjustments in the accounting standards and regulations or disrupt the work of audit function, which results in inconsistent enforcement (Al-Janadi & Rahman, 2016). Furthermore, Fan, Jiang, & Zhang (2023) stated that internal and external auditors may find themselves under coercive pressure posed by clients with political power, which may lead to compromising their objectivity and hence weakens their ability to challenge management.

The empirical research made in developing markets showed that political division is associated with poor external audit quality and higher frequency of cases involving audit opinion modifications (Houqe, Monem, & Zijl, 2022). In the banking industry, these negative results are worse as in banks auditors use and rely largely on incomplete regulatory data due to political instability. In Libyan context, the two rival authorities have implemented different financial regulations, and with auditors differently interpreting and applying international standards due to variations in experiences, this can lead to higher likelihood of misstatements and financial restatements later on.

Theoretical Foundation of the Relationship Between Political Instability and Financial Restatement:

The institutional theory and agency theory can be adopted to form the theoretical basis of the relationship between political instability and financial restatement. Institutional theory suggests the institutional situation surrounding organizations plays a role in shaping the organizational behavior. When political and governing institutions weaken, the that organizational behavior is shaped by the surrounding institutional environment; when political institutions weaken, the norms and customs that support transparency and accountability become less effective in such an environment, leading to poor financial reporting quality (North, 1990). In addition, agency theory added that weak monitoring, resulted from political instability, increases information asymmetry between managers and principals due to the adoption of opportunistic behavior by both parties, which leads to higher risk of financial restatement (Jensen & Meckling, 1976). Thus, both theories suggest that political instability does not only disrupts banks' governance systems, but it shapes auditors' behavior by shaping their interests and incentives that might increase the risk of issuing false financial reports.

Existing body of literature has largely explored the issue of financial restatements in developed stable economies with strong institutional frameworks (e.g., Hennes et al., 2008; Palmrose et al., 2004). However, only a few studies have addressed the dimension of politics in the topic of financial reporting quality in fragile countries such as Libya (Aljaaidi et al., 2021). Additionally, empirical evidence from Libya or other North African countries remains rare. Therefore, this study tries to bridge this gap in the literature by providing evidence from external auditors who audited banks in the city of Tripoli as it offers unique conditions characterized by continued political instability. Furthermore, through examining how political instability affects the ability of auditors to discover and prevent errors and misstatements, the current research provides deeper understanding of financial reporting under circumstances of political uncertainty and suggests several measures to managers, law and policymakers to boost organizational trust through improving the financial reporting integrity in post-conflict environments.

Study Hypothesis:

H1: Political instability has a significant positive effect on financial restatement in Libyan banks

Methodology:

Research Design:

This research uses quantitative research design in investigating the effect of political instability on financial restatement rate in Libyan banks from Libyan auditors' point of view. This approach is appropriate as it facilitates the application of systematic testing of the hypothesized relationship between dependent and independent variables through the use of measurable data (Creswell & Creswell, 2018). The current study adopts a cross-sectional survey, since the data were collected by surveying external auditors working in Tripoli at one time to capture their opinion regarding how political instability affects financial restatement and the overall quality of financial reporting process.

Study Population and Sample:

The population of the study comprises external auditors at audit firms that have previously provided audit and consultation services to banks operating in the city of Tripoli, Libya. The Libyan Association of certified Auditors (2024), there are about 112 licensed auditors in the city of Tripoli. Therefore, the purposive sampling was adopted to make sure that all participants are auditors who has directly experienced auditing of Libyan banks in Tripoli. Thus, out of 93 questionnaires that distributed, only 74 questionnaires were received and regarded as valid useable for the analysis. this response rate of 80% is acceptable for social science studies (Sekaran & Bougie, 2019).

Questionnaire Development:

The data were collected using a structured questionnaire that was based in its design on previous studies. Measurement items were adopted and adapted to the Libyan context. Furthermore, the questionnaire was divided into three main parts:

The first section of the questionnaire is the control variables such as Auditors' gender, auditors' experience, and auditor's qualifications, which regarded as control variables, because they these could affect audit outcomes and reporting quality as stated by previous studies (DeFond & Zhang, 2014). The independent variable which is the political instability was measured by 8 items that were adapted from two past studies (Aisen & Veiga, 2013; Aljaaidi, Bagudo, & Abdulrahman, 2021). These 8 items are used to detect auditors' views regarding policy randomness, government intervention, political division, and regulatory inconsistency. Auditors' responses were measured using a five-point Likert scale, values range from 1 that represents strongly disagree to 5 which indicates strongly agree opinion. The dependent variable of the study is the financial restatement that is measured using 7 items adopted from previous studies (Hennes, Leone, & Miller 2008; Chen, Hribar, & Melessa, 2018). These seven measurement items are utilized to capture the perceived extent, occurrence, and reasons of financial restatement in the Libyan banks.

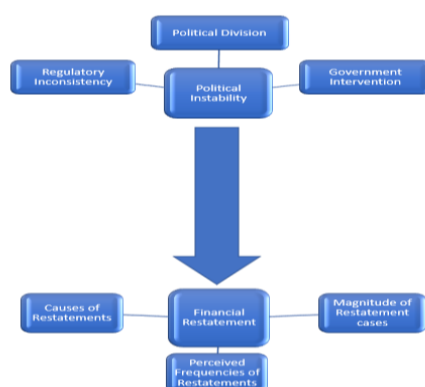


Figure (1): measurement model of the Study

Questionnaire Validity and Reliability:

To certify the questionnaire's content validity, the original questionnaire was examined and reviewed by four academic experts in the field of auditing as well as three professional auditors who are familiar with auditing in Libyan banks. Some amendments were made to ensure clarity and facilitate understating. Then, a pilot study was done using 40 questionnaires distributed to auditors to ensure acceptable reliability and understanding. Pilot study therefore ran Cronbach's alpha test by using Smart PLS 4.0 software, which showed values exceeding the suggested threshold of 0.70 for all study constructs, which confirms internal consistency (Hair et al., 2021). Then, test for construct validity was ran to assess construct validity through convergent and discriminant validity by using Smart PLS 4.0 software.

Data Collection Stage:

Having done the Pilot study, formal questionnaires were distributed physically on auditors working at auditing firms in Tripoli in the period from mid-October to mid-November 2025. The questionnaire was accompanied with a cover letter clarifying the study purpose, indicating that all responses will be held confidential and going to be used for academic research only.

Data Analysis Technique:

Data collected were analyzed by Smart PLS 4.0 program. The study used Partial Least Squares Structural Equation Modeling "PLS-SEM" to examine the relationship between political instability and financial restatement. PLS-SEM was used as it is suitable for predictive research and because it is appropriate for small and medium study sample sizes (Hair et al., 2021). The PLS-SEM model of the study was analyzed in two stages:

First stage involves the assessment of measurement model, wherein indicator reliability, internal consistency, and validity of constructs were assessed through certain tests.

Second stage involves assessing the structural model, the model here is used to test the hypothesized direct relationship between political instability and financial restatement while taking into account the effect of control variables such the characteristics of auditor and auditing firm. Also, bootstrapping with 5,000 resamples was ran to assess the significance level of path coefficients of the study constructs, and then the explanatory power of the PLS model was evaluated through test of R square values, test of effect sizes (f square), and lastly test of the predictive relevance (Q square).

Results and Analysis:

Questionnaire Response and Missing Values:

A total of 93 questionnaires were handed to external auditors working in the city of Tripoli, Libya. Only 74 valid responses were collected, giving a response rate of 79.5%, which is sufficient for conducting quantitative studies that use professional respondents (Hair et al., 2021). Before the analysis, the dataset was screened for missing values, outliers, and normality. Missing responses reported less than 2% of the total, which were substituted by using the method "mean substitution". Furthermore, all constructs illustrated adequate levels of skewness and kurtosis (± 2), which suggests approximate normality (Kline, 2016).

Assessment of the Measurement Model:

To measure the reliability and validity of model used in this study, the study uses different tests depending on the type of study constructs. For the reflective construct (political instability), the study uses Indicator reliability, internal consistency reliability, convergent validity and discriminant validity. For the formative constructs (Financial restatement), the study uses multicollinearity test and the significance and relevance of outer weights via bootstrapping.

Indicator Reliability:

As it can be seen from table 1, all outer loadings related to reflective indicators are above the threshold of 0.70, showing a satisfactory level of reliability (Hair et al., 2021). only one item from the political instability construct (PI5) was removed due to its loading recording below 0.60.

Table (1): Items and Their Respective Loadings for the Study Model

Variables	Items	Outer Loadings	Removed Items	Loadings of Removed Items
EA	EA1	0.723		
	EA2	0.620		
	EA3	0.664		
FR	FR1	0.605		
	FR2	0.697		
	FR3	0.713		
	FR4	0.841		
	FR5	0.820		
	FR6	0.699		
	FR7	0.641		
PS	PS1	0.715	PS5	0.587
	PS2	0.627		
	PS3	0.743		
	PS4	0.951		
	PS6	0.622		
	PS7	0.682		
	PS8	0.623		

Internal Consistency Reliability:

As shown in table 2, the values of Cronbach's alpha and Composite Reliability (CR) for all of the study constructs recorded above the threshold of 0.70, which means internal consistency has been confirmed.

Table 2: Cronbach's Alpha Values

Latent Construct	Cronbach's Alpha (CA)
Political Stability	0.767
Financial Restatement	0.819

Convergent Validity

Table 3 indicates that the values of Average Variance Extracted (AVE) recorded more than the threshold of 0.50 for both study constructs, which means the convergent validity of the model has been confirmed (Fornell & Larcker, 1981).

Table (3): Average Variance Extracted of the Constructs

Latent Construct	Average Variance Extracted (AVE)
Political Stability	0.659
Financial Restatement	0.843

Discriminant Validity:

The discriminant validity was tested by applying Fornell–Larcker measure and Heterotrait–Monotrait Ratio (HTMT). Table 4 shows that each study construct's square root of AVE recorded a value that is larger than the value of its correlations with other study constructs. Also, according to table 5, all HTMT values recorded values that are less than 0.85, proving the model's discriminant validity.

Table (4): Fornell-Larcker Discriminant Validity Analysis for The Model of the Study

	FR	PS
FR	0.812	
PS	0.055	0.918

Table (5): Heterotrait-Monotrait Ratio (HTMT) For the Study Model

	FR	PS
FR		
PS	0.110	

Assessment of the Structural Model:

Measuring the collinearity of variables is necessary prior to the analysis of the interrelationships between these variables. This assessment is crucial because of the fact that if the independent variable has a problem of multi-collinearity, it will be difficult to assess the independent variable's individual impact on the dependent variable because multicollinear variables often become almost similar (Hair et al., 2010). Furthermore, the collinearity between the variables is often assessed by VIF values, where the value of VIF, that is less than 5, is seen as an indicator on collinearity not establishing a problem in the study.

The structural model in this study was evaluated by measuring collinearity, path coefficients, coefficient of determination (R square), effect size (F square), and predictive relevance (Q square). Table 6 shows that the VIF values for all of the study constructs recorded values less than 5, which means no multicollinearity issues exist (Diamantopoulos & Siguaw, 2006).

Table (6): VIF (Collinearity Measures) for the study model

Variables	VIF
Political Stability	1.020
Financial Restatement	1.129

Coefficient of Determination (R²):

As it is seen in Table 7, the R² value for Financial Restatement was 0.42, meaning that the independent variable "Political Instability" and control variables explain 42% of the variance in the dependent variable "Financial Restatement" among Libyan external auditors. According to Cohen, 1988, this R² value indicates a moderate level of explanatory power of the model.

Table (7): Coefficients of Determination (R²)

dependent variable	R-square	size
Financial Restatement	0.42	Moderate

Hypothesis Testing:

To test the hypothesized effect of political instability on financial restatement, bootstrapping with 5,000 resamples has been carried out. Table 8 shows the hypothesis testing results.

Table (8): Results of Hypotheses Testing

H	Relationship	Path Coefficient	T - value	P - values	Decision
H1	PS->FR	0.423	2.722	0.007***	Supported

The result reveals a significant positive effect of political instability on financial restatement in Libyan banks ($\beta = 0.42$, $p < 0.01$). This indicates that higher levels of political instability are associated with greater occurrences of financial restatement.

Effect Size (f^2):

It was stated by Chin (2010) that effect size (f^2) is an indicator that simply shows the degree of the effect that one of the independent variables has on the dependent variable. The effect size detects R^2 values variance after ignoring or excluding each of the independent variables in the model. Whereas (R^2) value refers to the total or combined effect of all independent variables on the dependent variable in the model without excluding any independent variable. Therefore, the effect size (f^2) is applied to evaluate the effect of independent variable on the dependent variable in complex models many independent or control variables. Effect size (f^2) of a construct is statistically found by the following formula:

$$f^2 = \frac{R^2_{\text{included}} - R^2_{\text{excluded}}}{1 - R^2_{\text{included}}}$$

- R^2 Included: The R^2 product in the structural model for the endogenous variable when the exogenous variable is included in the calculation of the R^2 .
- R^2 Excluded; means is the R^2 product for the endogenous variable in the structural model when the exogenous variable is not included in the R^2 's calculation.

Table 9 indicates that the effect size of political instability on financial restatement recorded 0.24, which suggests a statistical medium effect according to Cohen's (1988) guidelines.

Table (9): Effect Size of the Exogenous Variable (PS) on Endogenous Variable (FR)

Exogenous Latent Construct	f-square	Effect sizes
Political Instability	0.240	Medium

Predictive Relevance (Q^2):

Table 10 illustrates that the value of Q^2 for financial restatement recorded 0.31, which means the model has a substantial predictive relevance.

Table (10): Stone–Geisser Q^2 for Endogenous Variable (FR)

	Q^2_{predict}	RMSE	MAE
FR	0.311147800	0.655830312	0.532174215

Control Variables:

The control variables, auditor experience and bank type indicated insignificant influences on financial restatement.

Summary of Findings:

The practical findings show that political instability has a significant positive effect on financial restatement in Libyan banking institutions. These results are supported by previous research work, which found that politically unstable conditions weaken enforcement of regulations, violate independence of external auditors, which leads to increasing level of financial misreporting (Hossain et al., 2020; Aljaaidi et al., 2021). These findings also emphasize the vulnerability of Libyan banks to pressure from external political forces and underline the significance of institutional stability for enhancing the quality of financial reporting.

Discussion:

This study has found that there is a significant positive bond between political instability and financial restatement in Libyan banks. In other words, political turbulence in the shape of governance fragmentation, inconsistency of regulation enforcement, and the frequency of policy changes, is linked to the financial restatement. Meaning the higher the level of political instability is the higher the level of financial restatement in Libyan banks. Moreover, the study findings highlight the importance of politically stable environment in sustaining the quality of financial reporting. These findings are also in accordance to the theoretical expectations founded by institutional and agency theories.

The significant positive relationship observed in this study is supported by earlier work that found political instability being a weakening factor for governance structures, regulatory oversight, and external audit quality (Agyei-Mensah, 2019; Aljaaidi et al., 2021). In politically unstable conditions, bank management is able to benefit from gaps in regulations to manipulate bank's financial statements, which leads to higher number of misstatements, resulting to the need for financial restatement to correct the financial statements (Hennes, Leone, & Miller, 2008). Likewise, external auditors who work in politically unstable environment is confronted with many challenges in finding reliable proof and protecting their independence, thus growing the audit risk associated with undetected errors and misstatements (Al-Janadi & Rahman, 2016; Fan, Jiang, & Zhang, 2023).

The results of the current study are also in accordance with past research that has been conducted on other developing and war-affected countries, where political uncertainty and institutional weakness were found to be key causes of poor quality of financial reports (Houqe, Monem, & Zijl, 2022). However, this study is unlike previous studies that were mainly conducted on developed markets possessing stable institutions (Palmrose, Richardson, & Scholz, 2004), the current study established an empirical evidence in the Libyan context, which highlights the significance of political environment as a key factor in the process of financial reporting and its integrity.

Conclusion:

This research has investigated the influence of political instability on financial restatement in Libyan banks, using data collected from 74 external auditors working in the city of Tripoli. The results show that there is a significant positive influence, indicating that the situation of political turbulence existing in Libya (represented in governance fragmentation, regulation inconsistency, and the frequent changes in policy) is positively associated with the risk of financial restatements in Libyan banks. This finding suggests that political instability weakens institutional frameworks that are fundamental for a reliable process of financial reporting and undermines the independence and quality of external audit function. From a theoretical perspective, this research underpins the institutional theory by indicating the way through which unstable political and regulatory settings outline organizational behavior. From agency theory perspective, the study support agency theory by demonstrating that weakened oversight and control as well as the exercised political pressures impair information asymmetry between management and stakeholders.

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