From Board Diversity to Firm Performance: The Mediating Role of Earnings Management

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ABSTRACT

The growing focus on board composition in corporate governance may be due to the board's potential to bring in a wider range of knowledge, skills, experience, and perspective from its diverse directors. Previous studies, however, have yielded ambiguous results on the link between board diversity and firm performance, and clarification of the mechanism of the link is needed. This conceptual paper aims to discuss a framework that will highlight the role of opportunistic earnings management as a mediating mechanism between board diversity and firm performance. Board diversity is understood as a multidimensional human capital of directors, including education, professional qualifications, industry knowledge and demography. The paper argues that the Human Capital Theory offers an explanation that diversity in the director brings a valuable resource into the strategic decision-making and organisational capabilities. Agency Theory describes how these resources might improve board monitoring, alleviate information asymmetry and limit the opportunistic behavior of managers regarding financial reporting. Based on this, the framework assumes that the more diverse the board is, the better the firm performs and that the more opportunistic the earnings management, the worse the firm performs, and that the worse the firm performs, the more negative the earnings management is. Hence, earnings management is hypothesized to partially mediate the relationship between board diversity and organizational outcomes. The paper builds on the ongoing debate by taking a multi-faceted view of human capital rather than a demography-driven one. It combines elements of both the Human Capital Theory and the Agency Theory to give a more complete account of such relationships. The framework is still conceptual and needs to be tested empirically but serves as a basis for future analysis of the diversity of boards, financial reporting systems and firm performance in diverse organisational and institutional settings. The framework also emphasises that the different abilities of the board and the appropriate monitoring are essential elements in enhancing corporate governance.

Keywords: board diversity, earnings management, firm performance, Human Capital Theory, Agency Theory

INTRODUCTION

Board diversity is an important issue in corporate governance because boards monitor management, advise on strategy, and add knowledge and expertise to corporate decision-making. Diversity in a team of directors may come from various types of human-capital characteristics (e.g., education, professional skills), from various types of demographic characteristics (e.g., age, gender, nationality), or from a combination of both of these types of characteristics. Thus, a board with diverse backgrounds could also provide more resources and perspectives.

Although many studies have examined this, no clear correlation exists between board diversity and firm performance. In the systematic review of 511 studies, Lu et al. (2022) noted significant variations in definitions, measures, theories, and results of board research. They also noted that attention to board diversity has been predominantly gender-based and that theory integration is limited. This suggests that board diversity's effect on performance should not be viewed in isolation and that researchers should consider the mechanisms through which diverse boards affect organizational performance.

The potential value of board diversity is explained by Human Capital Theory. Becker (1964) believes that knowledge, skills, and abilities are productive resources. At the corporate level, directors' education, expertise, and experience can be seen as human capital that supports and informs the board's decision-making and governance. For instance, Saha and Maji (2022) examined board human capital diversity in the top 100 listed Indian companies and found that diversity in both educational qualifications and gender was significantly associated with financial performance. Their research supports the notion that board diversity can be an organizational asset, not just a demographic fact.

Another potentially important mechanism is managerial financial reporting behavior. Agency Theory suggests that separation between ownership and management creates potential conflicts of interest and information asymmetry (Jensen & Meckling, 1976). Managers may therefore have opportunities and incentives to engage in opportunistic behavior, including earnings management. A board with diverse knowledge and expertise may be better equipped to monitor management and scrutinize financial reporting decisions.

Previous studies provide evidence of a relationship between board diversity and earnings management. Roy and Alfan (2022), using 393 Malaysian listed companies, found that gender diversity was associated with lower accrual-based earnings management. Alves (2023), based on 3,808 non-financial European Union listed companies, also reported a negative relationship between female board representation and earnings management. Attia et al. (2024) similarly found evidence that greater board gender diversity was generally associated with lower earnings manipulation among Egyptian listed companies.

Importantly, recent evidence has already examined earnings management as a mediating mechanism. Majumder et al. (2024) found that earnings management partially mediated the relationship between board gender diversity and firm performance among listed energy firms in Bangladesh, India, and Pakistan. Thus, this paper does not claim that this mediation relationship has never been studied. Instead, this paper broadens the discussion by conceptualizing board diversity as multidimensional board-level human capital and integrating Human Capital Theory and Agency Theory to explain the proposed mechanism.

Accordingly, this paper develops a conceptual framework linking board diversity, opportunistic earnings management, and firm performance. The framework proposes that diverse board-level human capital may strengthen monitoring, reduce opportunistic earnings management, and consequently contribute to firm performance.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Board diversity and firm performance

Board diversity refers to heterogeneity among directors in terms of demographic and human-capital characteristics. While gender diversity has received substantial attention, a broader conceptualization includes education, professional expertise, industry experience, financial knowledge, age, nationality, and other characteristics that may influence directors' perspectives and capabilities. Human Capital Theory suggests that these differences can provide firms with a broader pool of knowledge and skills. Directors with different experiences may contribute alternative perspectives, improve problem-solving, and enhance strategic decision-making. This may strengthen the board's ability to advise management and evaluate corporate strategies.

Saha and Maji (2022) support this perspective by showing that educational and gender diversity on boards is associated with financial performance. However, the wider literature remains mixed. Lu et al. (2022) noted substantial variation across studies, suggesting that board diversity does not necessarily translate into superior performance in all circumstances.

One reason for these differences may be that the value of board diversity depends on how directors' diverse resources are utilized within the governance process. A diverse board may possess substantial human capital, but its contribution to performance may depend on its ability to monitor management and influence managerial behavior. Based on Human Capital Theory, the present study proposes:

H1: Board diversity is positively associated with firm performance.

Board diversity and opportunistic earnings management

Agency Theory is used to explain how board diversity can affect earnings management. The managers as a whole are likely to know more about the firm than the external shareholders and may have motives to distort what is reported for their own or their organization's benefit. Effective board monitoring can reduce this information asymmetry and, to some extent, limit managerial opportunism. Board diversity can strengthen this monitoring role by bringing directors' different knowledge and perspectives. For example, directors with financial, accounting, professional, or industry knowledge may be better able to detect unusual accounting transactions and question management's explanations.

Empirical evidence supports a negative relationship between board diversity and earnings management, but most of it concerns gender diversity. Roy and Alfan (2022) found that board gender diversity reduced earnings management through accrual accounting in Malaysian listed companies. Alves (2023) found the same relationship in a large sample of companies listed on European Union stock exchanges, while Attia et al. (2024) generally concluded that more female board members were associated with less earnings manipulation in Egypt.

The findings indicate that diversity can improve monitoring and supervision of financial reporting. However, given the overwhelming focus on gender, research needs to broaden board diversity to include a blend of demographic and human-capital (HC) attributes. The influence of diversity may also depend on directors' actual power within the board, rather than their presence alone. Future studies could therefore measure structural influence through committee chair positions and voting power, and test whether a critical mass, such as three or more diverse directors is needed before diversity meaningfully affects monitoring and earnings management. Therefore:

H2: Board diversity is negatively associated with opportunistic earnings management.

Opportunistic earnings management and firm performance

Earnings management may be accomplished in one of two ways: Accrual accounting methods or operating decisions. The effects are not always consistent, as the consequences of earnings management depend on its type, motives, and context. This study therefore addresses only opportunistic earnings management, which is behaviour that seeks to mislead investors about the actual performance of the company or to benefit management. Future empirical studies should distinguish accrual-based earnings management (AEM) from real earnings management (REM) and model them simultaneously as competing mediation pathways. This would help establish whether board diversity reduces overall opportunistic manipulation or whether managers shift from accounting choices to real operating decisions, such as reducing discretionary spending or altering production, to achieve reporting targets.

Under Agency Theory, earnings management can be considered opportunistic when it makes financial information less reliable and leads to inefficient decision-making. If earnings reporting is weak, investors and other stakeholders may make decisions based on false information.

Empirical research provides evidence that earnings management can adversely affect performance. In the setting of open-market repurchases, Gong et al. (2008) discovered that abnormal accruals associated with earnings management were negatively related to future performance. Huang and Sun (2017) similarly found a positive relationship between real earnings management and future firm performance, and that managerial ability affected this relationship. However, the relationship can't be considered always negative. Dyreng et al. (2022) showed that the effects of earnings management can be situation-dependent and/or depend on the nature of the earnings manipulation. This further highlights the need to concentrate especially on opportunistic earnings management in the current framework. Opportunistic earnings management can have negative consequences for the quality of financial reporting and for the allocation of resources. Therefore:

H3: Opportunistic earnings management is negatively associated with firm performance.

Mediating role of opportunistic earnings management

The proposed mediation relationship integrates Human Capital Theory and Agency Theory. Human Capital Theory explains how diverse directors may provide the board with heterogeneous knowledge, skills, expertise, and experience. Agency Theory explains how these resources may improve monitoring and reduce managerial opportunism. Accordingly, board diversity may influence firm performance partly through its effect on managerial financial reporting behavior. A board with diverse expertise may better scrutinize financial reporting and constrain opportunistic earnings management. Reduced opportunistic earnings management may then improve the credibility of reported information and contribute to better organizational outcomes.

Majumder et al. (2024) provide direct empirical evidence that earnings management can mediate the relationship between board gender diversity and firm performance. However, their focus is specifically on gender diversity. The present conceptual framework extends this line of research by treating board diversity as a broader form of board-level human capital.

H4: Opportunistic earnings management mediates the relationship between board diversity and firm performance.

Theoretical Foundation

Human Capital Theory

Human Capital Theory, proposed by Becker (1964), posits that knowledge, skills, training and experience are assets that can help to improve the productivity of individuals and the ability of organizations. This theory implies that directors in the context of corporate governance help the organization by their varied skills and professional knowledge, training and years of experience. Board diversity is not simply a snapshot of diversity in the composition of the people on the board, but a multi-dimensional human capital that can enhance the total human capital of the board. Diverse professional and educational perspectives can lead to more comprehensive views and better problem-solving, as well as better-informed strategic decisions.

Accounting and financial directors can offer useful information on financial reporting, for instance, while directors with business experience can assist the board on risks and strategic opportunities to the business. These complementary skills can complement the advisory role of the board and help the firm perform better. But it is not enough to have a variety of human resources to attain excellent organisational performance. How the directors use their knowledge and expertise to make decisions and manage the business is the key to the value of board diversity. Saha and Maji (2022) offer evidence that supports this conclusion by arguing that board human capital diversity is related to firm performance.

In this regard, the Human Capital Theory is used to theorize a positive association between board diversity and firm performance (H1). It also provides a guide to how directors' differing knowledge and expertise can help them to scrutinise the actions of managers and the financial reporting more effectively.

Agency Theory

The Theory of the Agency was developed by Jensen & Meckling (1976), and it is a theory that describes the possible conflicts of interest in the separation of ownership and management. For managers, as the agents of the shareholders, may have more information about the company's operations and financial situation than the external owners. This information asymmetry can lead to management decision-making that is based on self-interest instead of shareholder interest. This can include opportunistic earnings management, which is designed to manipulate reported financial results, or to hide a company's actual performance, in financial reporting.

A monitoring role for the board of directors is very important in addressing these agency problems. A diverse board, with members from different professional backgrounds and financial and industry knowledge, may be able to ask more questions about management decisions, uncovering less obvious accounting practices, and assessing whether financial reporting judgments are appropriate. These powers can re-enforce corporate

oversight and diminish opportunities to opportunistic earnings management. Thus, Agency Theory lends support to the hypothesized negative relationship between board diversity and opportunistic earnings management (H2).

In addition, the opportunistic earnings management could affect the reliability and credibility of financial information, which could make the financial information misleading to investors and other stakeholders and cause them to make inappropriate economic decisions. This can also have a negative effect on investor confidence and have negative implications for long-term organisational results. Based on this, we propose that there is a negative relationship between opportunistic earnings management and firm performance (H3).

Integration of Human Capital Theory and Agency Theory

Combining the Human Capital Theory and Agency Theory gives a more complete account of the link between board diversity and firm performance. Human Capital Theory provides an explanation for the array of resources that various directors contribute to the board, while Agency Theory provides an explanation of how these resources can be used to enhance monitoring and limit managerial opportunism.

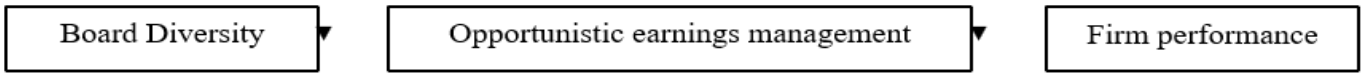
From this holistic point of view, there are two ways in which board diversity can have an impact on firm performance. First, the different knowledge, skills and experience of directors can have a direct impact on strategic decision making and organisational capacities. Second, these powers could enhance financial reporting oversight and decrease the opportunity for opportunistic earnings management, which would help to make financial reporting more credible and support improved firm performance.

Therefore, opportunistic earnings management is suggested as a mediator between board diversity and firm performance. In this regard, this integrated theoretical lens provides greater support for H4 than the discussion of a direct link between board diversity and firm performance would suggest. It highlights that board diversity can also benefit from the resources that are available within the board, as well as from the effectiveness of the use of those resources to monitor managerial behaviour and ensure the quality of the financial reporting.

CONCEPTUAL FRAMEWORK

Figure 1 illustrates the proposed conceptual framework, which depicts the direct relationship between board diversity and firm performance. Based on this framework, the following hypotheses are developed:

Figure 1: A Conceptual Framework of The Study



The conceptual framework integrates Human Capital Theory and Agency Theory to explain the proposed relationships. Human Capital Theory suggests that board diversity provides firms with heterogeneous knowledge, skills, education, expertise, and experience. Agency Theory suggests that these resources can strengthen board monitoring and constrain managerial opportunism. The framework therefore proposes that board diversity affects firm performance both directly and indirectly through opportunistic earnings management.

Table 1. Conceptualization and Measurement of the study variables

Element	Role	Role	Expected Relationship
Board Diversity	Independent Variable (IV)	Human Capital Theory: Enriches the board with diverse skills, professional experience, industry expertise, and educational backgrounds.	Predicts both lower earnings management and higher performance.

Opportunistic Earnings Management	Mediating Variable (MV)	Agency Theory: Represents managerial opportunism and information asymmetry that can distort financial reporting credibility.	Serves as the middle pathway through which diversity impacts firm outcomes.
Firm Performance	Dependent Variable (DV)	Reflects overall corporate success and financial value resulting from strategic decisions and transparent reporting.	Outcome variable.

Thus, Agency Theory provides the principal theoretical explanation for the monitoring relationship between board diversity and opportunistic earnings management. At the same time, Human Capital Theory explains the value of diverse board-level resources.

Expected Contribution And Limitations

Expected contribution

This paper contributes to the literature in three important ways.

First, it extends the definition of board diversity. Board diversity is not just a demographic dimension, but multidimensional board-level human capital, differences in knowledge, skills, education, expertise, and experience.

Second, this paper identifies opportunistic earnings management as a potential path through which board diversity affects firm performance. This offers a more detailed explanation than just direct relationships between board characteristics and performance.

Third, the paper incorporates the Human Capital Theory and Agency Theory. Human Capital Theory captures the resources available through a diverse board, and Agency Theory explains how these resources can be used to better monitor and limit managerial opportunism. A more complete theoretical discussion of the proposed relationships.

Limitations

The framework is conceptual, so it does not provide empirical evidence to confirm the proposed relationships. Future studies will need to test the hypotheses to confirm them, and additional measures and research designs will be needed. Such testing should also address potential endogeneity, including reverse causality and omitted variables, before interpreting the mediation relationships causally. Depending on the research setting and data, future studies could consider dynamic panel Generalized Method of Moments (GMM) estimators, difference-in-differences designs around regulatory shocks, or instrumental-variable approaches, while clearly justifying the assumptions and limitations of each method.

Additionally, board diversity is multidimensional, and different dimensions can yield different results. These factors should therefore be studied individually as well as in combination, and future research should examine gender, education, professional background, and experience.

Lastly, the effects of earnings management can vary by type (accrual-based and real) and managerial motives. Future empirical testing should differentiate between these types.

CONCLUSION

This paper suggests a conceptual relationship between board diversity, opportunistic earnings management, and firm performance. Drawing on Human Capital Theory and Agency Theory, the framework suggests that diverse boards provide heterogeneous human capital that enhances monitoring of managerial behavior in financial reporting.

The main idea is that board diversity can positively affect firm performance both directly and indirectly by reducing opportunistic earnings management. The literature on earnings management as a mediator between board gender diversity and firm performance examines the concept from a limited perspective; however, this paper broadens the discussion by adopting a more multidimensional view of board diversity and incorporating both human-capital and agency perspectives.

The framework lays the groundwork for future empirical studies that explore the relationship between various types of board diversity and earnings management and firm performance in varying institutional and organizational environments.

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