

Board Governance, Earnings Management and Firm Financial Sustainability: A Conceptual Overview from The Perspectives of Emerging Economies

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ABSTRACT

The attainment of financial sustainability is of paramount importance for firms, as it guarantees their long-term viability and success. It enables organizations to navigate periods of economic decline, allocate resources towards expansion prospects, and fulfill their commitments to employees and stakeholders. By focusing on the Sustainable Development Goals (SDGs), this study aims to develop a conceptual framework for how board governance affects firms' financial sustainability, with earnings management as a mediating variable. This study posits that board governance is the primary determinant of firm financial sustainability, and earnings management is a key player in this relationship. To the best of our knowledge, this is the first study to consider the mediating effect of earnings management on the association between board governance and firm financial sustainability. The results of this study will be useful to regulators in addressing board governance issues to deter earnings management and improve firms' financial sustainability. The study will also add value as a battery for future research, particularly regarding the relationships between board governance and financial sustainability in emerging and developing economies with similar economic perspectives.

Keywords: *board governance, earnings management, financial sustainability*

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1. INTRODUCTION

Given the importance of sustainable development to business firms, academics, practitioners, and policymakers have become increasingly interested in firm sustainability issues in recent years. (Martínez-Ferrero & García-Meca, 2020; Orazalin & Baydauletov, 2020). Companies endeavor to address the persistent fluctuations in economic growth and resource management by embracing sustainability (Ahmed & Tirmizi, 2020). According to Bartolacci et al. (2018), enterprises must achieve sustainable financial performance to meet the realistic expectations of their owners and ensure the long-term survival and continued operation of the firms, thereby serving the best interests of all stakeholders. Nevertheless, the realm of sustainability management and reporting lacks adequate attention to financial sustainability in both theoretical study and practical application (Günther et al., 2020). Therefore, it is logical to enhance the existing body of literature by investigating the concept of financial sustainability.

The integration of sustainability as a prominent objective in corporate governance is evident (Günther et al., 2020). According to Okoye et al. (2017), a crucial element in achieving financial sustainability is a company's ability to maintain financial self-sufficiency while ensuring the integrity of its governance system and operations. Good governance aims to optimise resource utilisation in a manner that benefits both corporations and society, while also considering the interests of all stakeholders (Ahmed & Tirmizi, 2020). The connection between corporate governance and financial sustainability has garnered significant attention from academics, researchers, and policymakers in light of notable instances of corporate collapses and scandals, including but not limited to Enron, One Tel, and the recent financial crisis (Musallam, 2020). According to Adeyemi (2019), company failures can be attributed to insufficient internal control systems, ineffective management practices, and a dearth of proper risk management strategies. These factors have necessitated the establishment of robust corporate governance frameworks and the implementing of measures to enhance financial sustainability. Recent research indicates that the primary decision-making body within a firm is commonly identified as the board of directors (BoD) (García-Sánchez & Martínez-Ferrero, 2018; Naciti, 2019).

The primary objective of the board of directors is to create wealth and value for stakeholders. This entails supervising how enterprises respond to stakeholders' rights and demands (Hapsoro & Fadhilla, 2017). The primary responsibility of the board of directors is to establish and maintain effective procedures for regulating and controlling the company's activities. Additionally, the board is tasked with ensuring that the corporation upholds principles of accountability and transparency through information sharing (Dias et al., 2017). Within this framework, the significance of effective board governance cannot be overstated, as it fortifies corporate governance and facilitates the implementation of sustainability policies. This, in turn, empowers organisations to address sustainability challenges more effectively (Biswas et al., 2018; Wijethilake & Lama, 2019a). Nevertheless, a limited body of research examined the correlation between the composition of a company's board of directors and its adoption of sustainable practices (Naciti, 2019). Consequently, there is an increasing scholarly focus on the relationship between board governance and firms' financial sustainability.

Notably, studies on corporate governance conducted worldwide suggest that the effectiveness of corporate governance systems is heavily dependent on the institutional context (Oehmichen et al., 2017). Research on earnings management and financial sustainability in the context of board governance may offer valuable insights, as the institutional environment in emerging economies differs from that of developed countries. This disparity arises due to weaker institutional frameworks, declining market efficiency, greater dynamism in rapidly growing countries, and diverse cultural, philosophical, and religious traditions (Oehmichen, 2018).

Existing empirical studies have examined the relationship between board governance and firms' financial sustainability. However, the findings from these studies have been inconsistent and inconclusive (Al-Matari, 2020; Arora & Sharma, 2016; Farooque et al., 2020; Queiri et al., 2021; Duppati et al., 2019; Guney et al., 2020; Merendino & Melville, 2019; Assenga et al., 2018; Bhat et al., 2018). It is noteworthy that prior scholars have recommended including additional

relevant factors to reconcile the conflicting and varied findings on the links between board governance and financial sustainability. Previous studies have demonstrated that the effects of board governance on the long-term financial viability of firms are influenced by factors such as corporate social responsibility (CSR) (Saleh et al., 2021), family ownership (Al-Okaily & Naueihed, 2020), earnings management (Asghar et al., 2020), intellectual capital efficiency (Isola et al., 2020), environmental, social, & governance (ESG) (Ouni et al., 2020), product market competition (Sattar et al., 2020), political connections (Ullah & Kamal, 2020).

Moreover, several researchers have discovered that the effects of board governance on the financial sustainability of firms are mediated by capital structure (Detthamrong et al., 2017), managerial ability (Fernando et al., 2020), CSR (Galbreath, 2016), working capital management (Shahid et al., 2020), and intellectual capital (Shahwan & Fathalla, 2020).

Building on prior research, this study aims to contribute to the literature by proposing that earnings management may serve as a mediator in the relationship between board governance and financial sustainability. This proposition is supported by empirical evidence from previous studies, which have demonstrated a significant impact of board governance on earnings management (Al-Haddad & Whittington, 2019; Burghle & Al-Okdeh, 2020; Orazalin, 2020) and earnings management significantly affects firm financial sustainability (Dakhlallah et al., 2020; Dang et al., 2020; Dao & Ngo, 2020). Therefore, it is imperative to investigate the mediating role of earnings management in the relationship between board governance and companies' financial sustainability. Given the aforementioned discourse, this investigation endeavors to ascertain the solutions to the subsequent research questions (RQ):

i. Research Question 1: What is the impact of board governance on the financial sustainability of firms?

ii. Research Question 2: To what degree does the practice of earnings management serve as a mediator in the relationship between board governance and the financial sustainability of a firm?

2. THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

2.1. BOARD SIZE AND FIRM FINANCIAL SUSTAINABILITY

Resource dependency theory posits that the board of directors has access to a wide range of resources, including capital and expertise, from external environments. Consequently, a larger board size signifies the acquisition of more substantial resources for firms, thereby ultimately improving corporate performance (Azar et al., 2018; Mishra & Kapil, 2018). Numerous studies have provided empirical support for a positive association between the size of a company's board of directors and its financial sustainability metrics (Al-Matari, 2020; Buachoom, 2018; Farooque et al., 2020; Zhou et al., 2018). Thus, the following testable hypothesis is formulated:

***H1a:** Board size has a significant positive impact on firm financial sustainability.*

2.2. Board Independence and Firm Financial Sustainability

According to agency theory, the primary role of the independent board of directors is to safeguard shareholders' interests by overseeing and supervising the manager's actions, thereby mitigating agency costs (Fama & Jensen, 1983). According to Shao's (2019) analysis, the resource dependency theory posits that including an independent board of directors can facilitate the acquisition of diverse resources from external settings, leading to improved financial performance for the organisation. Moreover, Abidin et al. (2009) posit that an increased presence of independent directors is associated with enhanced corporate performance due to their ability to bring diverse backgrounds, personalities, qualities, and experience to board discussions, hence bolstering the efficacy of the decision-making process. In the extant body of literature, a cohort of researchers has discovered empirical evidence supporting the positive relationship between board independence and indices of firm financial sustainability. In the existing literature, a group of researchers found evidence of a positive linkage

between board independence and firm financial sustainability indicators (Ahmadi et al., 2018; Al-Matari, 2020; Buachoom, 2018; Farooque et al., 2020; Kao et al., 2019). Hence, based on the agency theory, literature, and judgments, this study puts forward the following hypothesis:

H1b: Board independence has a significant positive impact on firm financial sustainability.

2.3.Board Activeness and Firm Financial Sustainability

Agency theory posits that agency conflict arises from the division between ownership and control, leading agents (managers) to prioritise their self-interest (Jensen & Meckling, 1976). To mitigate this agency problem, board activeness plays a crucial role. By increasing the frequency of meetings, boards enhance their monitoring capacity over management functions, thereby improving firm financial performance (Buachoom, 2018; Nowland & Simon, 2018). According to Palaniappan (2017), the regular convening of board members signifies enhanced coordination in the firm's management by discussing crucial matters. As a result, the monitoring capability becomes more effective, reducing agency costs and ultimately boosting the firm's performance. A group of researchers found evidence of a positive association between board activity and firm financial sustainability indicators (Arora & Sharma, 2016; Buachoom, 2018; Farooque et al., 2020). Thus, the following testable hypothesis is formulated:

H1c: Board activeness has a significant positive impact on firm financial sustainability.

2.4.Board Gender Diversity and Firm Financial Sustainability

Diversity among board members has been found to contribute to aligning the interests of shareholders and management (Hillman & Dalziel, 2003), thereby mitigating agency costs as outlined in agency theory (Jensen & Meckling, 1976). Furthermore, including both male and female members on boards contributes to a diverse range of ideas, knowledge, perspectives, and experiences during the decision-making process. This diversity is crucial in enhancing firm performance by facilitating essential strategic functions such as advising and monitoring (Khosa, 2017; Ntim, 2015). Following resource dependence theory, Ntim (2015) posits that board diversity can influence the firm by facilitating the acquisition of essential resources, including but not limited to experience, legitimacy, prestige, and talent, from the external environment. Moreover, several previous studies posit that the presence of women on corporate boards positively affects firms' financial performance. This is primarily attributed to their superior decision-making abilities (Bart & McQueen, 2013), higher attendance rates in board meetings relative to their male counterparts (Huse & Solberg, 2005), enhanced public image, increased creativity, and superior understanding of market conditions (Smith et al., 2006), as well as their exceptional listening and communication skills (Julizaerna & Sori, 2012). A group of researchers also found evidence of a positive linkage between board gender diversity (female members on the board) and firm financial sustainability indicators (Ahmadi et al., 2018; Assenga et al., 2018; Đặng et al., 2020; Green & Homroy, 2018; Song et al., 2020). Thus, the following testable hypothesis is formulated:

H1d: Board gender diversity has a significant positive impact on firm financial sustainability.

2.5.Audit Committee Size and Firm Financial Sustainability

Based on the tenets of resource dependency theory, it can be posited that a larger composition of audit committee members is indicative of a greater level of expertise and knowledge within the committee. This enhanced proficiency facilitates more effective oversight of the operations conducted by the board (Bataineh & Soumadi, 2020; Ghosh et al., 2010). According to Farooque et al. (2020), a substantial audit committee possesses extensive knowledge and experience, which successfully enhances monitoring capabilities and ultimately improves corporate performance. A group of researchers has found positive linkages between audit committee size & firm financial sustainability indicators (Al-Okaily & Naueihed, 2020; Bagais & Aljaaidi, 2020; Bataineh & Soumadi, 2020; Musallam, 2020; Rahman et al., 2019). Thus, the study put forward the following testable hypothesis:

H1e: Audit committee size has significant positive impacts on firm financial sustainability.

2.6 Audit Committee Independence and Firm Financial Sustainability

Agency theory posits that agency costs emerge due to divergent self-interests between principals and agents (Jensen & Meckling, 1976). The inclusion of independent directors on the audit committee serves to mitigate agency problems (Erickson et al., 2005), thereby enhancing the effectiveness of the audit committee in improving firm performance (Musallam, 2020). According to Musallam (2020), evidence supports the agency hypothesis, which posits that the autonomy of audit committee members is vital in making sound judgements and identifying errors without barriers because of the independent reviewers. According to Farooque et al. (2020), an independent audit committee is associated with enhanced efficacy in overseeing the board's acts. This, in turn, contributes to the optimization of shareholders' wealth and the organization's overall performance. A group of researchers has found a positive linkage between audit committee independence & firm financial sustainability indicators (Bansal & Sharma, 2019; Bataineh & Soumadi, 2020; Javad et al., 2017). Thus, the following testable hypothesis is formulated:

H1f: Audit committee independence has a significant positive impact on firm financial sustainability.

2.7 Audit Committee Activeness and Firm Financial Sustainability

The concept of agency theory places significant emphasis on the role of the board of directors in safeguarding the interests of shareholders by the monitoring and control of managerial activities, hence mitigating agency costs (Fama & Jensen, 1983). The board of directors' appointment of an audit committee serves to enhance the board's monitoring function. This is achieved by the increased frequency of meetings held by the audit committee members, which facilitates the exchange of opinions and enables effective monitoring of the business activities and its management (Al-Okaily & Naueihed, 2020). Moreover, Farooque et al. (2020) posit that the regularity of audit committee meetings indicates the proactive engagement of both internal and external auditors in effectively overseeing the responsibilities of executives. This, in turn, mitigates the likelihood of fraudulent activities within the firm and ultimately enhances firm performance. A group of researchers have found evidence of positive linkages between audit committee activeness & firm financial sustainability indicators (Al-Okaily & Naueihed, 2020; Bansal & Sharma, 2019; Barka & Legendre, 2017; Bataineh & Soumadi, 2020; Farooque et al., 2020; Musallam, 2020). Thus, the following testable hypothesis is formulated:

H1g: Audit committee activeness has significant positive impacts on firm financial sustainability.

2.8 Audit Committee Financial Expertise and Firm Financial Sustainability

The audit committee members' proficiency in accounting and finance is crucial in scrutinising the organisation's financial information, effectively ensuring firm performance (Musallam, 2020). According to Al-Okaily & Naueihed (2020), financial competence among audit committee members facilitates the oversight of managerial activities and the selection of accounting information reporting methods. As a result, this reduces opportunistic behaviour by managers and ultimately leads to decreased agency costs. Furthermore, researchers have found positive linkages between audit committee financial expertise & firm financial sustainability indicators (Al-Okaily & Naueihed, 2020; Javad et al., 2017; Musallam, 2020; Salehi et al., 2018). Thus, the following testable hypothesis is formulated:

H1h: Audit committee financial expertise has significant positive impacts on firm financial sustainability.

2.9 Risk Management and Firm Financial Sustainability

According to Musallam (2020), risk management offers value to organizations and contributes to the mitigation of general economic growth by reducing capital costs and addressing uncertainties associated with industrial activities. The disclosure of risk issues can be crucial in enhancing corporate performance, as highlighted by Azizah (2020). According to Jensen &

Meckling (1976), the provision of accounting reports and disclosure of information might potentially reduce the costs associated with two forms of agency conflicts, namely compensation contracts and owner-debt holder contracts.

Additionally, these practices can enhance shareholders' confidence levels and mitigate information asymmetry. According to Buckby et al. (2015), an enhanced level of risk disclosure can indicate to stakeholders that an organization is committed to being accountable to them and adhering to effective corporate governance practices. According to Lockett et al. (2009), resource dependency theory posits that due to the typically limited nature of resources available to firms, managers who engage in behaviors that bolster the credibility of their organization are more likely to secure access to vital resources. Therefore, companies can enhance their market reputation by increasing the disclosure of risk-related information. This can lead to establishing more strategic alliances and attaining more favorable financing terms (Durnev et al., 2004). The presence of extensive risk disclosure may suggest that managers possess an understanding of the difficulties presented by both the internal and external environment. Furthermore, it indicates that they are implementing effective risk management strategies to mitigate these risks and ensure the organization's long-term sustainability (Jia et al., 2016). This, in turn, positively influences the firm's operational efficiency (Derouiche et al., 2021). The earlier studies also found that risk management positively affects firm performance (Halim et al., 2017; Musallam, 2020; Nahar et al., 2016). Thus, the study put forward the following testable hypothesis:

H1i: Risk management has a significant positive impact on firm financial sustainability.

2.10 Earnings Management as a Mediator between Board Governance and Firm Financial Sustainability

The efficacy of corporate governance is contingent upon the actions of the board of directors, who are responsible for authorizing and assessing the investment and financing endeavors of the organization (Detthamrong et al., 2017). The presence of robust or deficient corporate governance inside a corporation might potentially lead to managerial opportunistic behavior, such as manipulating earnings. According to the agency perspective, managers prioritize their self-interests over the owners' interests to obtain rewards from the firms, hence giving rise to agency conflicts (Jensen & Meckling, 1976). According to Puni & Anlesinya (2020), effective board governance can mitigate agency conflict that negatively impacts business performance. For instance, a substantial board offers significant assets in the form of extensive experiences, abilities, and expertise to businesses (Peasnell et al., 2005), aiding in overseeing managerial actions. The independent behavior of directors plays a crucial role in effectively monitoring and overseeing the operations of managers (Waweru & Prot, 2018). The regular convening of board meetings suggests an increased level of deliberation among board members about the various challenges the organization faces, including the measures the manager took. Female members on the board contribute to the variety of genders, which has been associated with a decrease in unethical behaviors. Research conducted by Wahid (2019) suggests that female board members are perceived as more ethical and socially responsible. Jensen & Meckling (1976) also highlight the significance of internal and external monitoring methods in mitigating conflicts of interest and knowledge asymmetry between shareholders and management. The audit committee qualities are of significant importance in this particular context as they mitigate managers' opportunistic behavior, specifically about earnings management. In line with the resource dependency hypothesis, empirical evidence suggests that a larger size of audit committee members is positively associated with enhanced expertise and knowledge within the committee, hence facilitating more effective oversight of board activities (Bataineh & Soumadi, 2020; Ghosh et al., 2010). Also, supporting the agency and resource dependency theory (Musallam, 2020) says that the autonomy of the audit committee members plays a significant role in determining the proper decisions and finding errors without obstacles because of the independent reviewers. According to Farooque et al. (2020), the regularity of audit committee meetings indicates the proactive engagement of internal and external auditors in efficiently overseeing the responsibilities of executives, hence mitigating the likelihood of fraudulent activities within the organization. According to Al-Okaily & Naueihed (2020) the presence of audit committee members with financial competence allows for effective monitoring of managerial activities and the selection of appropriate accounting information reporting methods. This, in turn, serves to mitigate opportunistic behavior by managers and ultimately leads to a reduction in agency costs. According to Jensen & Meckling (1976), utilizing accounting reports and information disclosure can mitigate two distinct forms of agency

conflicts: compensation contracts and owner-debt holder contracts. Furthermore, these practices can enhance shareholder trust and diminish information asymmetry. From this perspective, using risk disclosure in risk management can mitigate information asymmetry and curtail discretionary actions by managers in their earnings management practices.

Based on the preceding analysis, it is evident that board governance has the potential to mitigate managers' opportunistic conduct, such as earnings manipulation, by providing valuable resources and establishing an efficient monitoring system within organizations. Furthermore, as a consequence of declining the earnings manipulation by the manager incentivising them to enhance the firm's profitability through increased operational activities (Mahrani & Soewarno, 2018). Consequently, heightened operational operations improve the firm's financial standing, enabling managers to get incentives based on the profits earned from engaging in such activities instead of manipulating earnings (Mahrani & Soewarno, 2018). Therefore, it is anticipated that the manipulation of earnings could potentially serve as a mediator in the relationship between board governance and the financial sustainability of a company.

The empirical literature also suggests that earnings management can mediate the relationship between board governance and firm financial sustainability. The reasons behind this as some empirical studies have found board governance significantly affects earnings management (Al-Haddad & Whittington, 2019; Burghle & Al-Okdeh, 2020; Orazalin, 2020) and earnings management significantly affects to firm financial sustainability (Dakhlallh et al., 2020; Dang et al., 2020; Dao & Ngo, 2020). Thus, the study put forward the following testable hypotheses:

H2a: Accrual earnings management mediates the effect of board size on firm financial sustainability;

H2b: Real earnings management mediates the effect of board size on firm financial sustainability;

H2c: Accrual earnings management mediates the effect of board independence on firm financial sustainability; H2d: Real earnings management mediates the effect of board independence on firm financial sustainability; H2e: Accrual earnings management mediates the effect of board activeness on firm financial sustainability; H2f: Real earnings management mediates the effect of board activeness on firm financial sustainability;

H2g: Accrual earnings management mediates the effect of board gender diversity on firm financial sustainability;

H2h: Real earnings management mediates the effect of board gender diversity on firm financial sustainability.

H2i: Accrual earnings management mediates the effect of audit committee size on firm financial sustainability; H2j: Real earnings management mediates the effect of audit committee size on firm financial sustainability;

H2k: Accrual earnings management mediates the effect of audit committee independence on firm financial sustainability;

H2l: Real earnings management mediates the effect of audit committee independence on firm financial sustainability;

H2m: Accrual earnings management mediates the effect of audit committee activeness on firm financial sustainability;

H2n: Real earnings management mediates the effect of audit committee activeness on firm financial sustainability;

H2o: Accrual earnings management mediates the effect of audit committee financial expertise on firm financial

sustainability;

H2p: Real earnings management mediates the effect of audit committee financial expertise on firm financial sustainability.

H2q: Accrual earnings management mediates the effect of risk management on firm financial sustainability;

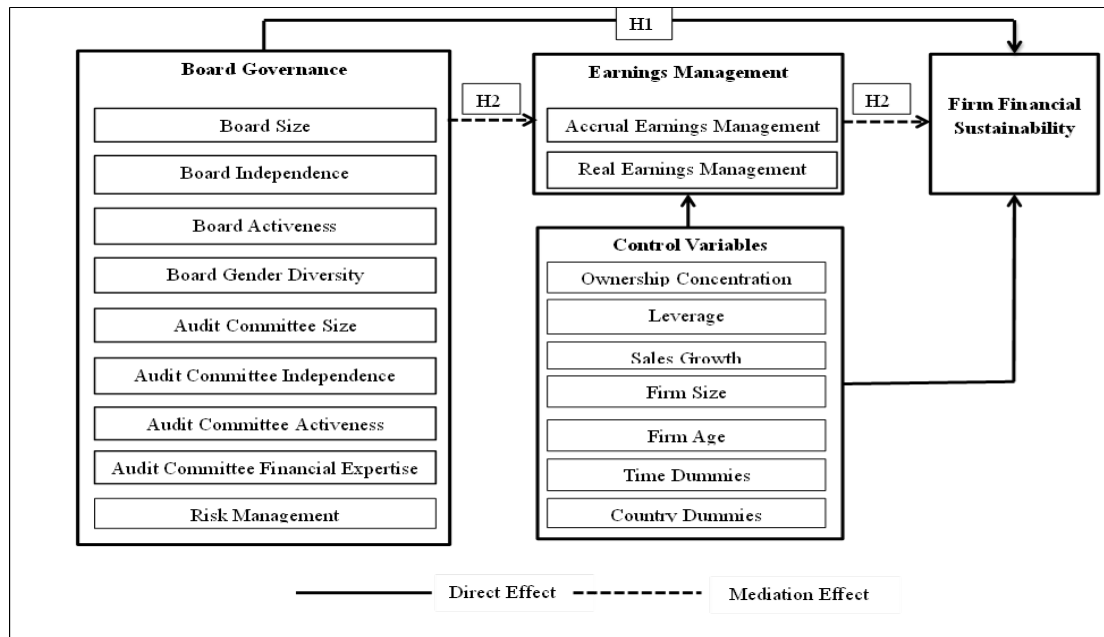
H2r: Real earnings management mediates the effect of risk management on firm financial sustainability.

3. CONCEPTUAL FRAMEWORK

This framework shows the direct and indirect relationship between the dependent and independent variables. The direct relationship indicates the association of board governance (namely, the board size, board independence, board activeness, board gender diversity, audit committee size, audit committee independence, audit committee activeness, audit committee financial expertise, and risk management) and firm financial sustainability. In the framework, the direct relationship between board governance and firm financial sustainability will be tested by hypothesis H1 (H1a to H1i). Finally, the framework shows the indirect effects on the dependent variable, i.e., the mediating effect of earnings management (AEM and REM) in the association between board governance and firm financial sustainability, where the testable hypothesis is H2 (H2a to H2r). The framework is supported by both the agency and resource dependence theories. The agency theory emphasises managerial incentives to motivate the manager to work for the interests of the principals. In contrast, the resource dependency theory asserts the various resources provided by the board to monitor a manager's activities without considering the managerial incentives. Thus, the two theories mean combining the board's ability to monitor and managerial incentives, which increases the monitoring effectiveness, thus reducing the manager's opportunistic behaviour (for example, earnings manipulation) and enhancing the firm financial sustainability. Figure 1 shows the conceptual framework below:

Figure 1.0

Relationship between Board Governance and Firm Financial Sustainability with the Mediation Effects of Earnings Management.



4. CONCLUSION

Based on agency theory and resource dependence theory, this study gives a conceptual framework for future researchers for the empirical investigation. The current study's conceptual framework mainly draws attention to investigating the mediating role of earnings management in the nexus between board governance and firm financial sustainability. The study developed the hypotheses based on theoretical points of view and considering the existing literature from the viewpoints of emerging economics perspectives. This study has some limitations that may be overcome by future researchers. The study ignores the other dimensions of sustainability, for example, environmental sustainability, social responsibility, etc. The future researcher can do a systematic literature review or cross-country empirical analysis using the proposed conceptual framework. Finally, the empirical findings using the proposed framework will help the policymaker to strengthen the current board governance practices in emerging economies to enhance firm financial sustainability.

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