Chapter 1
Theories Related to the Relationship Between Board Diversity, Earnings Management, and Firm Performance

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ABSTRACT

Previous research studies have used multiple theories, such as resource dependence, human capital, social capital, busyness, signalling, behavioural, and agency theories in order to investigate the association between board diversity and earnings management and the association between board diversity and firm performance. This chapter surveys 75 research studies and used 37 theories. Most of the studies focused on agency and resource dependent theories. Also, this study used social capital theory as a contribution of the chapter, which was rarely used and which examined the relationship between board diversity and earnings management in addition to firm performance.

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INTRODUCTION

Previous research studies have used multiple theories, such as resource dependence, human capital, social capital, busyness, signalling, behavioural and agency theories, in order to investigate the association between BD and earnings management and the association between BD and firm performance (FP). These studies have additionally investigated the impact of corporate governance codes (CGCs). As shown in Table 1, 75 research studies have used 37 theories. Moreover, as displayed in the chart below, 30 studies have used agency theory and 17 have used resource dependence theory. However, as shown in Table 1 and the chart below, 21 studies did not use any theory. This study contribution is used social capital theory to study the relationship between board diversity and earnings management, besides firm performance.

This research study uses agency and resource dependence theories, which are also those most commonly used in the literature (see Figure 6). Darmadi's (2011) used social capital theory to explain the relationship between BD and FP, while Kim and Lim (2010) used it to study the relationship between the diversity of independent outside directors and company valuation. Nevertheless, few other studies have used this theory in Kuwait. This study uses social capital theory due to its relevance in explaining the relationship between BD and EM as well as the relationship between BD and FP.

Consequently, social capital theory makes several contributions to this research study. The operations of a business firm increase both corporation and conflict. Conflict can occur between the owners and the managers of an organisation when it comes to the division of the value that the firm has created as well as among the BOD while struggling for power and control of rights within the firm. Thus, agency theory, resource dependence theory and social capital theory have been selected to analyse conflict and diversification, from three different perspectives. From the agency theory perspective, conflict among the directors of a company exists when managers at the headquarters are connected in an agency relationship with those in the operating division. However, while there is the incorporation of autonomous decision-making subsidiary managers, their decision-making autonomy may be categorised as discretion (Barroso-Castro et al., 2016). On the other hand, resource dependence theory posits that power is based on ruling over the resources that are considered to be strategic within an organisation and in most instances will be presented in terms of budget and the allocation of resources (Chisholm & Nielsen, 2010). The theory is externally focused and survival in a competitive environment will call for diversification in the BOD. Social capital theory seeks to create a connection between the internal and external environments of an organisation through diversifying the board by hiring females, young people and foreign directors. Thus, the three theories selected in the study provide a complementary framework within which we can understand the decision-making processes of diverse organisations based on gender, age, ND, those with resources and even the establishment of external connections.

There is an integrated relationship between social capital theory and resource dependence theory. Resource dependence theory aims to hire directors who are powerful and have a connection and a good resource better than letting other companies hire him or her. On the other hand, social capital theory focuses on the situation whereby a company needs to hire female, young and foreign directors who have good connections so that the firm can these for its own interests. Thus, we can stipulate that both theories focus on establishing a connection as the main aim for the firm to be competitive (Johnson et al., 2013). In resource dependence theory, the firm is seen as a pool of resources, including intangible resources, which are vital to creating a competitive advantage (Chisholm & Nielsen, 2010). Hence, social capital theory will figure prominently among the intangible resources in strengthening the analytical powers of