

## RELATIONSHIP BETWEEN THE FINANCIAL CAPABILITY OF INDEPENDENT DIRECTORS AND BOARD MONITORING EFFECTIVENESS

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### Abstract

The objective of this study is to examine the relationship between financial capability of independent directors and the monitoring of the companies of interest by the independent directors. The sample comprises 50 firms over the period 2020-25 and the analysis is done using fixed effects and dynamic estimation methods, where earnings management is used as a proxy for board monitoring. Independent Directors' financial capability is negatively correlated and statistically significant with earnings management, indicating that the greater the financial capability, the better the monitoring. The results are very strong after accounting for endogeneity problems. The rest of the control variables in the model have the following relation with earnings management: Firm age negatively relates with earnings management, the size of the firm has a weak positive relation with earnings management, and the Board size is not significant. The study contributes to previous work by emphasizing that director effectiveness is not just related to independence but to financial skills, and implications for the practice and design of corporate governance.

**Keywords:** Financial capability, Board monitoring, Earnings management, India, Panel data

### Introduction

Corporate governance has been an important mechanism for smooth working of corporations and the alignment of the interests of all stakeholders of modern corporations. In a large company, there is a separation of ownership and management, which generally creates an agency problem that needs oversight mechanisms for smooth functioning and reducing conflicts. To address these agency problems, independent directors are positioned as key actors through their advisory functions and monitoring skills (Wang et al., 2015; Omer et al., 2020). The effectiveness of independent directors depends entirely on their financial capability, knowledge, and expertise across various financial and accounting contexts (Shah et al., 2026). In modern corporate scenarios, the relationship between financial capability and expertise in accounting matters of independent directors and the effectiveness of board monitoring is very important. Directors rely on financial expertise to meet their fiduciary duty and look out for shareholders (Wang et al., 2015). With a complex understanding of financial issues and not heavily depending upon the corporate performance interpretations of the management, independent directors can escape from the information asymmetry (Omer et al., 2020). Financial literacy also helps the directors to



possess the evaluative and comparative ability to deconstruct complex financial disclosures, challenge executive decisions and identify aggressive accounting practices regarding capital allocation (He et al., 2019).

Financial literacy means the capability of a person to acquire skills in accounting, knowing capital markets and corporate finance, which help them to monitor the effectiveness through various channels, such as the reduction of information asymmetry, oversight of internal control and financial reporting analysis (Alfraih, 2016). The former ensures the company's data is accurate and compliant, the latter brings in high-level experience in investment strategy, risk management, and supervisory oversight (Lu et al., 2022; Porter & Sherwood, 2023). By balancing these two dimensions as one focused on the fine print of the books and the other on the big picture of the market, a board can move beyond simple number-crunching to achieve truly effective governance and long-term foresight (Yahaya, 2026; Shah et al., 2026).

Financial literacy is not about having technical knowledge related to financial risk, but also includes the understanding and use of various analytical tools and methodologies. Other than these, it also extends to having familiarity with emerging issues like cryptocurrency exposure and cybersecurity risks (Putra, 2023). Educational credentials serve as one primary indicator of financial capability. Directors possessing advanced degrees in accounting, finance, business administration, or related fields generally demonstrate higher baseline financial literacy. Directors must not only understand financial statements but also interpret them critically, identify inconsistencies that might signal manipulation or fraud, and ask penetrating questions of management and auditors (Lu et al., 2022; Porter & Sherwood, 2023). This capability of financial judgement comes from experience and deliberate involvement in real-time problems rather than only theoretical knowledge (Huynh et al., 2023). Academic-trained financial experts may differ in effectiveness from those with practitioner experience (Bettingtona & Nicholson, 2025). Beyond formal degrees, a director's real-world professional history serves as a vital second pillar of financial capability. Career paths in auditing, banking, or corporate finance provide a "boots on the ground" perspective, building the kind of practical intuition and tacit knowledge that simply can't be taught in a classroom (Porter & Sherwood, 2023). This experience is further sharpened by time and professional connections; as directors spend more years in governance or take on roles at multiple companies, they develop a broader comparative lens. This "network effect" allows them to spot subtle red flags, benchmark performance against the rest of the industry, and quickly identify when a company is drifting away from established best practices (Hamid & Purbawangsa, 2022).

The board of directors, as an integral element of a firm's corporate governance system, performs the dual role of monitoring and advising top management. Whereas all directors can contribute to the advisory function, the monitoring duty mostly falls to independent directors. Not surprisingly, improving board independence was a major emphasis of the corporate governance reforms and regulations following high-profile corporate scandals in the early 2000s (Li et al., 2024). Much of the academic literature on corporate boards also focuses on director independence and its effects on firm performance and decision making.<sup>1</sup> Although independence determines directors' monitoring incentive and is a necessary condition for boards' effective oversight of management, what also matters is whether independent directors can perform their monitoring duty (Putra, 2023).



Board monitoring effectiveness operates through interconnected mechanisms that vary in immediacy and impact. At the most direct level, financially capable independent directors conduct rigorous oversight of financial reporting processes. The mechanism of monitoring becomes strong with time and experience as the directors attend regular audit meetings, detailed financial statement review and analysis, and most importantly, a critical and deep understanding of significant accounting judgements. Such regular interaction directly improve accounting quality (He et al., 2019; Akinsola & Taofeek, 2025).

When audit committees are packed with financial experts, they become far more effective at catching and fixing serious reporting errors before they spiral (Apochi et al., 2022; Hamid & Purbawangsa, 2022). These directors aren't just there to nod along; independent experts are often the first to speak up against risky proposals and can spot red flags that others might miss (Riele et al., 2022). Boards with financially experienced independent directors are proactive rather than reactive, stopping fraud before it happens (Li et al., 2023). This oversight extends to keeping an eye on executive pay and insider deals; active directors with accounting backgrounds are highly successful at reducing unfair related-party transactions (Majid et al., 2023).

Financially knowledgeable independent directors more successfully face the related-party transactions (Majid et al., 2023). The audit committee serves as an important connection between financial expertise and effective oversight. It also helps the independent directors to utilize their ability to supervise financial reporting, internal controls, and risk management (Shah et al., 2026). Many studies on audit committees show a positive correlation between financial expertise and enhanced financial reporting quality (Li et al., 2023; Oladapo et al., 2026). Research on Nigerian corporates found that financial expertise on audit committees, along with board independence and size, significantly improved financial reporting quality and strengthened the connection between other governance attributes and reporting outcomes (Akinsola & Taofeek, 2025).

The theoretical explanation of this concept is mainly based on two theories: Resource dependence theory and Agency theory of corporate governance. Resource dependence theory states that directors with financial expertise help to arrange new financial resources at an effective cost of capital. This helps to reduce the overall cost of capital and improve the performance of the company (Akram et al., 2023). Agency theory states that financial expert directors help to make effective financial decisions, reduce uncertainty and improve financial decision quality (Gwala & Mashau, 2023). Together, these theories show how financial know-how shapes a board's impact. It tightens oversight and keeps managers in check, while also raising the level of strategic advice the board can offer.

### **Review of Literature**

The role of independent directors with financial expertise in restricting earnings management and improving corporate governance has been widely examined in recent literature. Yahaya (2026) found that board independence alone is not enough unless complemented by audit committee expertise, highlighting the importance of specialised financial knowledge in corporate governance mechanisms. Krishnamoorthy et al. (2022) showed that the accounting expertise of the audit committee chair improves oversight effectiveness, leading to higher audit quality. Similarly, Bettington and Nicholson (2025) emphasised that financial literacy of the independent directors enhances monitoring effectiveness, thereby reducing opportunistic managerial



behaviour. Shah et al. (2026) found the positive impact of human capital efficiency and value-added intellectual capital on the ROE of the financial firms. Akinsole (2025) explored the multifaceted role played by an independent director in today's corporatised and modern world and concluded that increasing complexity in the globalised market and cross-border regulatory environment have made their job more challenging and important.

Adeyemi and Yahaya (2024) also confirmed that the board-level financial expertise improves earnings quality by strengthening monitoring functions. Karajeh (2023) found that effective audit committees strengthen the relationship between financial reporting quality and shareholder value, indicating broader governance benefits. Riele et al. (2022) concluded the discussion by linking board characteristics, including expertise, to overall firm performance.

Bugter (2025) demonstrated that director experience and independence, especially in fraud-prone environments, strengthen oversight capabilities. Oreshile and Adeneye (2025) revealed that financial expertise mitigates risks associated with overboarding, ensuring more effective governance. Jingwei et al. (2024) highlighted that independent directors' attributes influence tunneling activities, with strong internal controls acting as a moderating factor. Finally, Zhang and Shailer (2022) underscored the importance of diligence among independent directors, particularly within audit committees, in limiting tunnelling practices. Porter and Sherwood (2023) observed 1248 firms between 2001 and 2008 and observed that firms that achieve increased board independence through increased board size are associated with higher financial reporting quality. Li (2024) concludes that financially expert chairs (FECs) are less effective in firms with high ownership concentration or strong political connections, which is supported by corporate governance literature, through the lens of Agency Theory and Resource Dependency Theory. Usman and Yahaya (2024) observed a negative association between board independence and earnings management, as independent directors play an important role in curbing opportunistic financial reporting.

Sharma et al. (2025) found the positive association between regular audit committees and earnings management in New Zealand firms. Carcello et al. (2006) demonstrated that audit committee financial expertise significantly reduces earnings manipulation. Sabiya et al. (2025) highlighted that independence, financial expertise, and share ownership collectively enhance financial reporting quality.

### **Research Methodology**

The study adopts quantitative research design with panel data approach to examine the effectiveness of financial skill of independent directors on the monitoring of the board. We have tracked 50 different listed companies over a consistent period of 6 years (2020 - 2025) to provide a balanced data set, which takes into account hidden differences between companies and trends across time, making findings much more reliable. The companies were carefully selected because they offered full financial and management information. We sourced hard financial data such as net profits and total assets from the CMIE Prowess database and added further board-specific data from board reports from annual reports and official corporate governance disclosures.

To estimate discretionary accruals, the study employs the Modified Jones Model:

$$TA_{it}/A_{it-1} = \alpha_1(1/A_{it-1}) + \alpha_2(\Delta REV_{it} - \Delta REC_{it}) + \alpha_3(PPE_{it}) + \epsilon_{it}$$

Where:

- $TA$  = Total accruals
- $A$  = Total assets
- $\Delta REV$  = Change in revenue
- $\Delta REC$  = Change in receivables
- $PPE$  = Property, plant, and equipment

To examine the relationship between financial capability and board monitoring, the following panel regression model is estimated:

$$EM_{it} = \alpha + \beta_1 FCID_{it} + \beta_2 FS_{it} + \beta_3 BS_{it} + \beta_4 AGE_{it} + \epsilon_{it}$$

Where:

- $EM_{it}$  = Earnings management (board monitoring proxy)
- $FCID_{it}$  = Financial capability of independent directors
- $FS_{it}, BS_{it}, AGE_{it}$  = Control variables
- $\epsilon_{it}$  = Error term

**Table 1 Variable Description**

| Category                                         | Variable                                         | Symbol | Measurement                                                             |
|--------------------------------------------------|--------------------------------------------------|--------|-------------------------------------------------------------------------|
| <b>Dependent Variable<br/>(Board Monitoring)</b> | Earnings Management                              | EM     | Discretionary Accruals<br>(Modified Jones Model)                        |
| <b>Independent Variable</b>                      | Financial Capability of<br>Independent Directors | FCID   | Composite index (financial<br>expertise, board strength,<br>audit role) |
| <b>Control Variables</b>                         | Firm Size                                        | FS     | Log of total assets                                                     |



|  |            |     |                           |
|--|------------|-----|---------------------------|
|  | Board Size | BS  | Total number of directors |
|  | Firm Age   | AGE | Years since incorporation |

Source: Author's calculations

**Table 2: Descriptive Statistics**

| Variable  | EM   | FCID | FS    | BS    | AGE   |
|-----------|------|------|-------|-------|-------|
| Mean      | 0.06 | 0.57 | 14.29 | 9.10  | 24.56 |
| Std. Dev. | 0.04 | 0.21 | 1.23  | 2.29  | 11.44 |
| Min       | 0.02 | 0.12 | 11.10 | 5.00  | 3.00  |
| Max       | 0.20 | 0.93 | 17.65 | 15.00 | 65.00 |
| Obs       | 300  | 300  | 300   | 300   | 300   |

Source: Author's calculations

Table 2 provides the descriptive statistics of the variables that were utilized in the study. The average value of earnings management (EM) is 0.06. The average value of the financial capability of independent directors (FCID) is 0.57 meaning more than half of the board of directors on average have the financial expertise and relevant capability. The mean of firm size (FS) is 14.29, which suggests that the sample consists of relatively large firms, which is not surprising due to the usage of listed companies. The values of board size (BS) are 9.10 directors, which indicates moderately sized boards, as per the governance norms. The mean age of firms is 24.56 years and this means that the sample of firms is dominated by firms that are mature and well-established. The values of the standard deviations indicate that there is a moderate variability across firms, especially in the case of AGE (11.44), which implies that there is diversity in the maturity of firms. The range of the minimum and maximum values further proves the idea that the dataset represents a big variety of firms in terms of their size, structure of governance, and their age.

**Table 3: Correlation Matrix**

| Variable | EM    | FCID | FS   | BS   | AGE |
|----------|-------|------|------|------|-----|
| EM       | 1     |      |      |      |     |
| FCID     | -0.32 | 1    |      |      |     |
| FS       | 0.28  | 0.35 | 1    |      |     |
| BS       | 0.18  | 0.22 | 0.23 | 1    |     |
| AGE      | -0.46 | 0.15 | 0.46 | 0.31 | 1   |

Source: Author's calculations

Table 3 indicates the correlation coefficient between the variables. FCID and EM have negative relationship of -0.32. The size of firms (FS) correlates positively with EM (0.28), indicating that larger firms can experience a



bit higher earnings management, possibly because of the increased complexity of operations. Board size (BS) also shows weak positive correlation with EM (0.18), which implies that it does not have a strong effect on monitoring. The age of a firm (AGE) is moderately and negatively correlated with EM (-0.46), meaning that older firms are less likely to manipulate their earnings.

**Table 4: Multicollinearity Test (VIF)**

| Variable        | VIF         |
|-----------------|-------------|
| FCID            | 2.14        |
| FS              | 1.92        |
| BS              | 2.37        |
| AGE             | 1.85        |
| <b>Mean VIF</b> | <b>2.07</b> |

Source: Author's calculations

The findings of the multicollinearity test based on the Variance Inflation Factor (VIF) are shown in Table 4. The values of VIF of all variables are between 1.85 and 2.37 with a mean value of VIF 2.07. This implies that the results are accurate and confirm that multicollinearity is not an issue with the model since the VIF values are all well below the generally accepted threshold of 10. This implies that, the independent and control variables are not highly correlated as such and that the regression estimates should be reliable and stable.

**Table 5: Model Selection Tests**

| Test               | Statistic | p-value | Decision               |
|--------------------|-----------|---------|------------------------|
| F-test (Chow Test) | 6.83      | 0.00    | Panel model preferred  |
| Hausman Test       | 14.38     | 0.00    | Fixed Effects selected |

Source: Author's calculations

The findings of the model selection processes are reported in table 5. The F-test (Chow test) shows a value of 6.83 ( $p < 0.01$ ), which means that the pooled OLS model is not suitable and that a panel data approach would be more appropriate to analyse the data. This implies that there are some unobserved firm-specific effects. In addition, the chi-square value obtained using the Hausman Test is 14.38 ( $p < 0.01$ ), which rejects the null hypothesis of the model of random effects being appropriate. The fixed effects model is therefore chosen as the preferred method of estimation as it effectively manages the time-invariant firm specific heterogeneity.

**Table 6: Regression Results (Fixed Effects Model)**

| Variable | Coefficient | Std. Error | t-Statistic | p-value |
|----------|-------------|------------|-------------|---------|
| FCID     | -0.38       | 0.07       | -3.86       | 0.04    |
| FS       | 0.03        | 0.03       | 1.78        | 0.07    |



|          |       |      |       |      |
|----------|-------|------|-------|------|
| BS       | 0.01  | 0.03 | 1.02  | 0.34 |
| AGE      | -0.01 | 0.02 | -2.26 | 0.03 |
| Constant | 0.26  | 0.06 | 2.49  | 0.02 |

Source: Author's calculations

The independent director financial capability coefficient (FCID) is statistically significant. This implies that increase in financial ability of independent directors will result in a decrease in earnings management, which will subsequently improve board monitoring performance. The observation is heavily compatible with agency theory, which indicates that, when there are effective monitoring mechanisms, managerial opportunism is reduced. The finding is also consistent with previous empirical studies. Burak et al. (2008) and Klein, April (2002) show that directors who have financial expertise are important in reducing the level of earnings management and enhancing board monitoring. Thus, the results are a solid indication of the hypothesis which states that financial capability increases monitoring effectiveness. In terms of control variables, the firm size (FS) demonstrates a positive and significant coefficient, which indicates that the larger the firm, the less control there is, and the possibility of such a control is increased. The size of a board (BS) is statistically insignificant, which shows that the number of directors does not significantly affect the monitoring effectiveness. The firm age (AGE) has a negative and significant coefficient ( $-0.01$ ,  $p < 0.05$ ) meaning that older firms are more likely to have more established governance practices and lower levels of earnings manipulation (Table 6).

**Table 7: Endogeneity Test (GMM Results)**

| Variable | Coefficient | z-Statistic | p-value |
|----------|-------------|-------------|---------|
| FCID     | -0.26       | -3.36       | 0.04    |
| FS       | 0.03        | 1.71        | 0.08    |
| BS       | 0.03        | 1.11        | 0.29    |
| AGE      | -0.02       | -2.12       | 0.05    |

Source: Author's calculations

The results of the dynamic panel estimation by the use of Generalized Method of Moments to overcome the possible endogeneity issues are reported in Table 7. The coefficient of FCID is negative ( $-0.26$ ) and statistically significant which proves the strength of the key results. This consistency implies that reverse causation or omitted variable bias does not cause the relationship between financial capability and reduced earnings management.

## Discussion

The current paper will discuss the presence of the financial ability of independent directors with the monitoring of the board proxied by the earnings management. The empirical evidence demonstrates that the financial ability of the independent directors (FCID) has a negative and statistically significant relationship with the earnings management, that is, financially competent independent directors lower the effectiveness of the board monitoring.



This finding is a strong indicator of the conclusions of the agency theory, which holds that financial expert directors help to make effective financial decisions, reduce uncertainty and improve financial decision quality. The results are in line with the original research conducted by Güner, A. Burak et al. (2008), who show that directors that have financial literacy play a significant role in influencing corporate decision making and governance outcomes. In the same vein, Klein, April (2002) determines that boards that have financially knowledgeable independent directors are linked with less level of earnings management. These findings also coincide with more recent findings that financial expertise enhances oversight roles and enhances the quality of financial reporting. As an example, Wang, Cong et al. (2015) reveal that directors with relevant expertise increase board monitoring by limiting manager discretion. The fact that the results of the study are consistent across baseline and robustness models further proves the point that financial capability is a crucial factor of governance effectiveness.

In terms of control variables, the size of firms (FS) has a weak positive correlation with earnings management, which implies that bigger companies may experience a greater level of complexity in their operations, which can provide them with additional opportunities of managerial discretion. This effect, however, is not always substantial which means that size is not the decisive factor of monitoring quality. This observation has been in line with the arguments of Watts, Ross and Zimmerman, Jerold (1986), who argue that larger firms are both more scrutinized and more complex, thus result in ambiguous outcomes. Board size (BS) is statistically insignificant and this means that an increase in the number of directors does not necessarily result in effective monitoring. This observation validates the thesis of Yermack, David (1996), who emphasizes the fact that bigger boards can be limitative due to the lack of the coordination and communication efficiency. On the other hand, firm age (AGE) indicates a negative, significant relationship with earnings management and a smaller level of financial manipulation.

## **Conclusion**

This study aims to show how the financial expertise of independent directors serves as a powerful boost to a board's oversight capabilities. Our findings clearly indicate that when independent directors bring financial expertise to the table, they are much more effective at curbing earnings management and strengthening overall board supervision. These results back up agency theory, highlighting that having competent directors isn't just a formality; it's a critical defines against managers who might otherwise put their own interests ahead of the company's. The robustness of the results is further supported by the dynamic panel estimation procedure which confirmed the finding that financial capability is a very important factor in good corporate governance. The control variables found to positively predict monitoring effectiveness are firm age, which indicates that over time, the older firms have a more robust governance system. On the other hand, there is no evidence that size has a significant impact on the quality of monitoring, suggesting that the quality of the directors may be more important than the quantity. This study is significant because it moves away from the concept of board independence to board capability. Previous studies have focused on the role of independent directors; this study shows that these independent directors need to be financially savvy and capable of understanding complicated financial information. The study has a number of limitations. Measurements of financial capability are restricted



by availability of data and by a limitation of firms in a sample over a particular period of time. Additional governance variables, cross-country comparisons and/or alternative measures of board monitoring could be incorporated into future research.

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