

# FINANCIAL FLEXIBILITY AS A MODERATOR OF CORPORATE GOVERNANCE EFFECTS ON SME PERFORMANCE AND RISK: EVIDENCE FROM THE EMERGING MARKET

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## Abstract

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This study investigates the relationship between corporate governance and financial flexibility in shaping performance and risk in small and medium-sized enterprises (SMEs) within developing economies. Unlike prior studies that treat governance as a static determinant, this research positions financial flexibility as a moderating factor that strengthens or weakens governance outcomes. Using panel data from 42 SMEs listed on the Indonesia Stock Exchange (IDX) from 2019 to 2023 (210 firm-year observations) and applying fixed- and random-effects regression models, the findings show that board independence improves firm valuation but has a limited influence on profitability in the absence of adequate liquidity. Gender-diverse boards help reduce financial risk when SMEs maintain sufficient reserves, while larger boards tend to increase leverage exposure. These results are consistent with Wen et al. (2023), who find that effective governance enhances firm value through stronger monitoring, and Settembre-Blundo et al. (2021), who highlight the importance of financial flexibility in supporting firms' resilience to risk. Theoretically, this study advances the governance literature by integrating agency resolution and financial capacity within the constraints of SMEs. Practically, it highlights the role of liquidity in strengthening governance mechanisms, providing valuable insights for investors and policymakers. The study provides a solid basis for reevaluating governance structures in emerging markets.

**Keywords:** Corporate Governance, Financial Flexibility, SME Performance, Risk Management, Board Independence, Institutional Ownership, Gender Diversity, Emerging Markets

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## 1. INTRODUCTION

Financial governance and financial flexibility are fundamental components of strategic management

in small and medium-sized enterprises (SMEs), especially in developing countries (Fatmawatie & Endri, 2022; Mbama & Mfelam, 2025). Governance mechanisms such as board diversity, board

independence, and institutional ownership are designed to strengthen oversight, reduce agency conflict, improve monitoring quality, and enhance decision-making. However, a growing body of global evidence shows that governance-liquidity misalignments are a critical SME vulnerability, with over 60% of SMEs reporting liquidity shortages (Organisation for Economic Co-operation and Development [OECD], 2022). More than 50% struggle to access external finance (World Bank, 2018), highlighting why conventional governance frameworks often fail in resource-constrained environments where financial flexibility is limited. In addition, empirical evidence on the effectiveness of these mechanisms remains inconsistent. Recent studies highlight that governance significantly influences firms' financial flexibility (Islam et al., 2022). However, there remain mixed findings on how governance variables, such as board independence and ownership structure, shape financial decisions (Aljughaiman & Salama, 2023). These inconsistencies indicate that financial flexibility may serve as a key moderating factor that has not been adequately explored.

This study integrates three major theoretical perspectives to explain how governance affects performance in SMEs. Agency theory by Jensen and Meckling (1976) argues that governance reduces conflicts between managers and owners, but financial constraints may weaken its effectiveness. Financial flexibility can moderate these conflicts by providing liquidity, enabling better control, and reducing opportunistic behaviour (Nazir & Afza, 2018; Kasbar et al., 2023).

Resource dependency theory by Pfeffer and Salancik (2006) emphasises that SMEs depend on external resources and must leverage governance structures to access financing. However, external resource optimisation is only effective when firms possess strong financial flexibility, allowing them to allocate resources efficiently (Lu et al., 2023).

Stewardship theory by Davis et al. (1997) offers a contrasting view, proposing that managers act as stewards who prioritise long-term stability. From this perspective, governance should emphasise sustainable financial practices that strengthen resilience and reduce risk (Shaheen et al., 2023). Previous studies also show that specific governance characteristics, such as family ownership, can influence decision-making and flexibility (Anderson & Reeb, 2003). Strong governance mechanisms can therefore mitigate financial constraints, although the interaction between governance effectiveness and financial flexibility has not been sufficiently examined (Begum & Begum, 2025; Hariyati et al., 2025; Larabi, 2025; Mehdaoui & Moufidi, 2025; Keasey et al., 2014).

This study investigates how board independence, institutional ownership, and gender diversity influence firm valuation, profitability, and financial risk in SMEs. By applying a panel regression approach, the research offers a dynamic assessment of governance effectiveness rather than a static evaluation of board composition.

The study addresses three main research questions:

*RQ1: How does governance structure affect SME performance and financial risk?*

*RQ2: To what extent does financial flexibility moderate governance effectiveness?*

*RQ3: Does gender diversity contribute to financial stability and profitability?*

Our contribution is threefold. First, the study challenges the assumption that independent boards or institutional ownership automatically improve performance, showing instead that financial flexibility is essential to fully leverage governance benefits (Napoli, 2012). Second, we clarify the role of gender diversity, demonstrating that female board participation is associated with more conservative financial policies and lower risk under stable financial conditions (Askarany et al., 2025). Third, we reassess board size, finding that although larger boards may increase oversight, they can also elevate financial risk unless supported by financial expertise and flexibility (Minton et al., 2011).

These findings highlight the need for policy interventions that strengthen SMEs' financial flexibility. Governments should consider tax incentives for maintaining financial reserves and expand capital market access to improve liquidity. Policies that encourage gender diversity, particularly support for women-led SMEs, may also enhance financial stability. Overall, this study offers a structured framework for improving SME governance by integrating financial flexibility, liquidity management, and inclusive leadership, helping SMEs in developing economies achieve more sustainable performance.

The rest of this paper is structured as follows. Section 2 reviews the relevant literature on financial flexibility, corporate governance, agency conflict, and SME performance, which forms the theoretical basis for this study, and develops a series of hypotheses that examine the direct and moderating effects of governance mechanisms, namely board diversity and institutional ownership, on performance and financial risk under varying levels of financial flexibility. Section 3 describes the research methods, including the sampling of SMEs listed on the Indonesia Stock Exchange (IDX), data collection procedures, and the statistical tools used, such as panel regression models, Hausman tests, variance inflation factor (VIF) analysis, and heteroscedasticity diagnostics. Section 4 presents the empirical research models, including the performance model, the risk model, and the moderation models integrating governance and financial flexibility interactions. Section 5 discusses the findings and implications. Section 6 concludes the paper.

## 2. THEORETICAL DISCUSSION AND HYPOTHESES DEVELOPMENT

### 2.1. SME performance

Free cash flow (FCF) is a key indicator of financial flexibility that significantly influences firm performance. In SMEs, excess liquidity without strong governance may lead to inefficient resource use, consistent with agency theory. Abughniem et al. (2020) found that FCF can improve performance, though its impact depends on governance structure and organisational context. Firm size also shapes valuation and operational efficiency. Larger SMEs often face valuation challenges due to market complexity and investor uncertainty, yet they benefit from economies of scale that enhance profitability. Cowling et al. (2018) highlight that firm size is a double-edged sword: growth increases operational

efficiency, but complicates market assessments. Thus, while larger SMEs gain from scale advantages, they also struggle to maintain market confidence, making the role of governance and financial discipline even more critical.

*H1: FCF negatively impacts operating income (EBITDA), indicating that greater financial flexibility leads to inefficient use of resources.*

Retained earnings to total assets (RETA) is an important indicator of internal financial flexibility, showing a firm's ability to fund operations and growth without relying on external financing. High RETA reflects financial discipline and long-term reinvestment. Prior studies show that firms prioritising reinvested profits tend to achieve higher valuations and stronger market resilience (Dechow & Ge, 2006; Guizani, 2018; Escandon-Barbosa & Salas-Paramo, 2024). However, RETA is also associated with higher debt-to-asset ratios (DAR) and greater earnings volatility, suggesting that firms with greater RETA may still pursue risky, aggressive growth strategies. This dual effect illustrates the complexity of financial flexibility. RETA can enhance firm value, but may also increase exposure to financial instability.

*H2: RETA significantly increase the valuation of firms and increases financial risk through higher leverage and higher earnings volatility.*

Cash flow is a fundamental factor in sustaining business operations. As cash flow is the lifeblood of an organisation, liquidity constraints negatively impact profitability, making financial distress a looming threat. Liquidity constraints that strain operating costs, investment, and resource development, as well as the ability to meet financial commitments, are the root cause of a firm's financial crisis. A company's capacity to improve profitability indicators like earnings before interest, taxes, depreciation, and amortisation (EBITDA) is severely limited by inadequate cash, which also hinders strategic agility. Accordingly, maintaining operational performance requires effective cash flow management and liquidity optimisation, particularly when resources are limited or financial results are unpredictable (Ahsan et al., 2016). Companies with poor liquidity management face significant barriers to increasing EBITDA, underscoring the importance of cash flow stability in sustaining business operations (Mittal & Raman, 2021; Nguyen & Nguyen, 2018).

*H3: Liquidity constraints have a negative impact on profitability.*

## 2.2. Governance, risk, and board characteristics

The implementation of good governance is essential to maintaining investor confidence and reflects business efficiency. While financial flexibility also plays a dominant role in encouraging strong operational efficiency through robust governance, this, in turn, increases market confidence. One independent board governance variable positively affects performance through the company's value (Tobin's Q), but it has no direct impact on EBITDA. Strong governance increases market confidence, but its ability to drive operational efficiency depends on financial flexibility (Fama & Jensen, 1983; Adams & Ferreira, 2009; Ciftci et al., 2019).

*H4: An independent board positively impacts performance through the Tobin's Q but has no direct impact on EBITDA.*

Women directors represent gender diversity, which is expected to tie performance and reduce risk. Furthermore, a few critical studies have shown that tokenistic representation, caused by structural biases, lowers corporate valuation. According to supporting research, female on board (FMOB) also improves financial performance by implementing sound risk management practices, making wise decisions, cultivating relationships with stakeholders, and planning for the long-term viability of the company (Post & Byron, 2015; Shaheen et al., 2023; Escandón-Barbosa et al., 2024). This implies that the environment affects the success of gender-diverse boards, particularly through the availability of institutional support and budgetary flexibility. The results of a study by Escandon-Barbosa and Salas-Paramo (2024) show that the presence of FMOB initially had an adverse effect on the company's value due to structural bias. However, it improved operational performance when supported by financial resources (Shaheen et al., 2023).

*H5: The presence of an FMOB has a negative effect on the firm's valuation, but can then improve operational performance when financial resources are well available.*

Institutional ownership can play an important role in establishing good financial stability. The presence of external investors will help the company reduce risk, potentially leading to a lower valuation. However, their presence helps companies maintain stability by implementing a firm reinvestment policy. As a result, institutional ownership reduces the company's valuation but reduces risk when combined with high RETA. Institutional ownership reduces the company's valuation due to external investor risk aversion (Kasbar et al., 2023) but lowers financial risk when earnings are held firmly, thereby increasing financial stability (Al-Najjar & Clark, 2017). However, in companies with weak reinvestment capacity, institutional ownership may fail to stabilise financial risk.

*H6: Institutional ownership reduces the valuation of a company but reduces risk when combined with high RETA.*

## 2.3. SME risks

Efficient asset utilisation is essential to maximise profitability. Efficient asset utilisation can drive profits, but it also creates financial instability unless supported by strong board oversight. Operational risk and profit volatility rise due to asset turnover, particularly when governance mechanisms are unable to manage aggressive revenue-generating tactics. Firms can maintain profitability and financial stability by leveraging strong board calibration and governance quality as a buffer to mitigate risks associated with high asset efficiency. Therefore, even if asset efficiency increases operating margins and return on assets (ROA), its full potential can be realised only when strong governance frameworks moderate its effects (Shah & Wan, 2024). Therefore, higher asset turnover increases earnings volatility but improves profitability under effective governance. Efficient asset utilisation can drive profits but also financial instability unless

supported by strong board oversight (Florackis, 2008; Fama & French, 2001; Chakabva et al., 2021).

*H7: Higher asset turnover increases earnings volatility but improves profitability under effective governance.*

Leadership decisions significantly impact the firm's financial policy and stability. While female chief executive officers (CEOs) adopt more conservative financial policies, leading to lower debt exposure, variations in their strategic decision-making may cause earnings fluctuations. Thus, female CEOs reduce debt risk but slightly increase earnings volatility. Women in leadership adopt more conservative financial policies, leading to lower debt exposure, but variations in strategic decision-making can cause earnings fluctuations (Shaheen et al., 2023; Adams & Ferreira, 2009; Saidat et al., 2019).

*H8: Female CEOs reduce debt risk but slightly increase earnings volatility.*

Governance structures can affect financial decision-making. While expanding governance structures may complicate financial decision-making, they still bring diverse expertise to bear. As such, larger boards increase debt risk, especially in asset-intensive firms. Furthermore, it has been noted that larger boards in asset-intensive companies favour debt financing over equity financing, as they are risk-averse, take longer to reach agreement, and prefer capital-intensive, outcomes-based operations. The extension of governance structures might therefore increase debt exposure and jeopardise liquidity control, particularly when it comes to unconditional financial flexibility or operational agility (Gerged et al., 2023; Nkwini et al., 2024). Expanding the governance structure may complicate financial decision-making, especially in firms with high asset dependence (Ali, 2018; Nkwini et al., 2024).

*H9: Larger boards contribute to increased debt risk, especially in asset-intensive firms.*

## 2.4. Moderating effects on governance and performance

Institutional ownership's risk effects depend on capital structure. Financial flexibility enables gender-diverse boards and independent governance to allocate resources efficiently, reducing liquidity constraints and increasing strategic investments, thereby improving performance (Guizani, 2018; Adams & Ferreira, 2009). A company's capital structure and liquidity posture determine the risk implications of institutional ownership. According to recent research, financial flexibility is essential to the efficient operation of governance systems, especially independent directorships and gender-diverse boards. Governance frameworks must support firms with high financial flexibility in managing agency disputes, allocating resources appropriately, and responding to market uncertainties. Therefore, companies with qualified, diverse, and impartial boards are more likely to alleviate liquidity constraints, pursue long-term value creation, and gain a competitive edge (Sajwani et al., 2024).

*H10: Gender diversity and independent boards have a positive effect on performance when financial flexibility is high.*

The implementation of risk-exposure mitigation strategies can vary across financial management systems. The presence of an effective governance mechanism can reduce financial risks; however, its effectiveness will depend on the company's liquidity and revenue strategy. The variables of institutional ownership and independent boards provide diversified risk-mitigation effects, depending on the financial structure. In practice, although this governance mechanism can reduce financial risks, its effectiveness depends heavily on effective liquidity management and corporate profitability (Kasbar et al., 2023; Liu & Hou, 2023). Financial risks can be minimised with the presence of institutional ownership, as it increases strong reinvestment capacity (RETA), but it can reduce the value of the business because it is constrained by obstacles to investing (Kasbar et al., 2023; Al-Najjar & Clark, 2017).

*H11: Institutional ownership and independent boards have a diverse effect in mitigating risk, depending on the financial structure.*

## 3. RESEARCH METHODS

### 3.1. Sample and data collection

This research uses a panel data approach, focusing on SMEs listed on the IDX between 2019 and 2023. Sample selection is based on the SME classification as outlined in Government Regulation No. 7 of 2021, which defines SMEs based on net asset value and annual revenue. From an initial pool of 200 SMEs, a final sample of 42 SMEs (210 firm-year observations) was selected based on firm compliance with corporate governance regulations, consistent financial reporting, and data completeness. This selection ensures that the sample represents financially stable SMEs with governance mechanisms aligned with regulatory requirements (Government Regulation (PP) Number 7 of 2021 concerning Facilitation, Protection, and Empowerment of Cooperatives and Micro, Small, and Medium Enterprises, 2021).

### 3.2. Data analysis and statistical tools

Panel regression analysis was conducted in STATA, using fixed- and random-effects models to control for unobserved heterogeneity across firms. A Hausman test was employed to determine the preferred specification, ensuring optimal model selection based on the data structure and governance characteristics (Baltagi, 2021). To ensure the statistical validity of the regression models, robustness checks were performed. A VIF analysis was conducted to detect potential multicollinearity among explanatory variables. Heteroscedasticity tests (Breusch-Pagan and White) were applied to assess the stability of variance in the panel data, thereby ensuring robustness of the model (Gujarati et al., 2009).

While this study employs panel data regression with fixed and random effects to account for unobserved heterogeneity, alternative econometric methods were also considered. For instance, the generalised method of moments (GMM) is often used in governance research to address dynamic endogeneity and reverse causality more rigorously. However, GMM typically requires a larger sample size ( $N$ ) relative to the time period ( $T$ ) to produce

stable estimates, which was a constraint given our specific sample of compliant SMEs. Similarly, structural equation modelling (SEM) could be used to analyse latent variables. However, since this study relies on observable financial metrics (ratios), panel regression was deemed the most robust and efficient method for the available dataset structure (Baltagi, 2021).

### 3.3. Research model

The research model evaluates the impact of agency conflict on SME performance and financial risk, incorporating corporate governance as a moderating factor. The empirical specification is as follows:

1) Performance model (governance, risk, and financial flexibility impact on performance):

$$Performance_{it} = \beta_0 + \beta_1 FinancialFlexibility_{it} + \beta_2 Governance_{it} + \beta_3 Risk_{(it)} + \beta_4 FirmSize_{(it)} + \beta_5 ROE_{(it)} + \beta_6 CurrentRatio_{(it)} + \varepsilon_{it} \quad (1)$$

2) Risk model (governance and financial flexibility effects on SME risk):

$$Risk_{it} = \beta_0 + \beta_1 Governance_{it} + \beta_2 FinancialFlexibility_{it} + \beta_3 (Governance \times FinancialFlexibility)_{it} + \beta_4 BoardSize_{(it)} + \beta_5 ROE_{(it)} + \beta_6 CurrentRatio_{(it)} + \varepsilon_{(it)} \quad (2)$$

3) Moderation model (governance and financial flexibility interactions) and performance moderation model (governance × financial flexibility on performance):

$$Performance_{it} = \beta_0 + \beta_1 Governance_{it} + \beta_2 FinancialFlexibility_{it} + \beta_3 (FMoB \times FinancialFlexibility)_{it} + \beta_4 (INSTOWN \times FinancialFlexibility)_{(it)} + \beta_5 ROE_{(it)} + \beta_6 CurrentRatio_{(it)} + \varepsilon_{(it)} \quad (3)$$

4) Risk moderation model (governance × financial flexibility on risk):

$$Risk_{it} = \beta_0 + \beta_1 Governance_{it} + \beta_2 FinancialFlexibility_{it} + \beta_3 (BoardSize \times FinancialFlexibility)_{it} + \beta_4 (INSTOWN \times FinancialFlexibility)_{(it)} + \beta_5 ROE_{(it)} + \beta_6 CurrentRatio_{(it)} + \varepsilon_{(it)} \quad (4)$$

where:

- *Performance* — Tobin's Q, EBITDA;
- *Risk* — EBITDA volatility, debt-to-asset ratio (DAR);
- *Governance* — board diversity, institutional ownership;
- *Financial flexibility* — retained earnings (RETA), free cash flow (FCF), asset turnover (AT), and sales, general & administrative (SG&A) expenses.

This model allows for an in-depth analysis of the direct and interactive effects of governance on SME outcomes.

These models assess the direct and moderating effects of governance mechanisms on conflict, performance, and risk of institutions, providing empirical insights into the governance framework required for SME sustainability.

Table 1. Measurement variables

| Type  | Variable                          | Measurement method  | Sources   |
|---|-----------------------------------|---|---|
| Dependent variables (Firm performance & Financial risk) | Tobin's Q                         | $\frac{\text{Market value of equity} + \text{Total liability}}{\text{Total asset}}$                                     | Claessens and Fan (2002), Govindan et al. (2023)  |
|   | EBITDA ratio                      | $\frac{\text{EBITDA}}{\text{Total asset}}$  | Dechow and Ge (2006), Buchanan et al. (2023)      |
|   | EBITDA volatility                 | The standard deviation of EBITDA over the study period, calculated as:<br>$\sqrt{\frac{\sum (EBITDA_i - EBITDA)^2}{n}}$ | Allen et al. (2023)                               |
|   | Debt-to-asset ratio (DAR)         | $\frac{\text{Total debt}}{\text{Total asset}}$  | Shaheen et al. (2023)                             |
| Independent variables (Financial flexibility)           | Free cash flow (FCF)              | Operating cash flow minus capital expenditures  | Brush (2000), Zhang et al. (2022)                 |
|   | Asset turnover (AT) ratio         | $\frac{\text{Net sales}}{\text{Total asset}}$   | Florackis (2008)                                  |
|   | SG&A expense ratio                | $\frac{\text{SG\&A}}{\text{Total operating income}}$  | Anderson et al. (2007)                            |
|   | Return on total assets (RETA)     | $\frac{\text{Total operating income}}{\text{Total asset}}$  | Ramadhan et al. (2021)                            |
| Moderating variables (Corporate governance)             | Female member on board (FMoB)     | Dummy variable: 1 if there is at least one female director, zero otherwise  | Terjesen et al. (2016), Brahma et al. (2021)      |
|   | Female CEO (FMCEO)                | Dummy variable: 1 if the female director is an executive director, zero otherwise                                       | Zhang et al. (2022)                               |
|   | Board size                        | Total number of directors on the board  | Adams and Mehran (2003), Mehrotra et al. (2021)   |
|   | Institutional ownership (INSTOWN) | The sum of the proportion of company shares held by institutional investors relative to total outstanding shares        | Lin and Fu (2017), Garcia-Meca et al. (2018)      |
| Control variables                                       | Firm size                         | Natural logarithm of total assets (ln total assets)   | Cowling et al. (2018)                             |
|   | Liquidity                         | $\frac{\text{Current assets}}{\text{Current liability}}$  | Mohanty and Mehrotra (2018), Sharma and Ho (2022) |
|   | Profitability (ROE)               | $\frac{\text{Net income (Before tax)}}{\text{Total equity}}$  | Govindan et al. (2023)                            |

Source: Authors' elaboration.

## 4. RESULT

### 4.1. Descriptive analysis

Before presenting the summary of descriptive statistics, this study provides an overview of the dataset and variables used in the empirical analysis. The sample comprises 42 SMEs listed on the IDX during 2019–2023, yielding 210 firm-year observations that capture variation in financial flexibility, corporate governance, firm performance, and financial risk. Key variables include indicators of

financial flexibility (RETA, FCF, AT, and SG&A), governance mechanisms (board diversity and INSTOWN), performance measures (*Tobin's Q* and *EBITDA*), and risk metrics (*EBITDA* volatility and *DAR*), supported by control variables such as firm size, ROE, and current ratio (CR). The descriptive statistics serve as an essential preliminary step to illustrate the distribution and characteristics of the data, ensuring that the variables are suitable for further panel regression testing and robustness analysis.

**Table 2.** Summary of descriptive statistics

| Variable                 | Obs. | Mean       | Std. dev. | Min        | Max       |
|--------------------------|------|------------|-----------|------------|-----------|
| <i>Tobin's Q</i>         | 210  | 1.379.567  | 2.046.125 | -1.239.835 | 8.888.872 |
| <i>EBITDA</i>            | 210  | 2.168.052  | 2.722.765 | 1.015.825  | 2.710.359 |
| <i>EBITDA volatility</i> | 210  | 0.0213566  | 0.0729389 | 4.70e-06   | 0.5742865 |
| <i>DAR</i>               | 210  | 3.628542   | 16.32388  | 0.0070317  | 146.2113  |
| <i>FCF</i>               | 210  | 1.352.835  | 829.985   | -1.364.026 | 9.549.516 |
| <i>ATO</i>               | 210  | 0.8797792  | 2.345.342 | 0.001086   | 2.916.519 |
| <i>SG&amp;A</i>          | 210  | 1.317.886  | 5.227.567 | -0.6779656 | 5.683.737 |
| <i>RETA</i>              | 210  | 5.898.377  | 228.346   | 0          | 1.823.946 |
| <i>FMCEO_d</i>           | 210  | 0.4761905  | 0.5006262 | 0          | 1         |
| <i>FMoB_d</i>            | 210  | 0.4761905  | 0.5006262 | 0          | 1         |
| <i>BoardSize</i>         | 210  | 2.428.571  | 0.8341645 | 0          | 5         |
| <i>INTOWN</i>            | 210  | 0.7574978  | 1.172.831 | 0          | 8.094.324 |
| <i>FIRMSIZE_C</i>        | 210  | 2.454.582  | 1.688.543 | 1.798.368  | 273.368   |
| <i>CR_C</i>              | 210  | 1.477.916  | 4.925.133 | 0.0065507  | 4.102.414 |
| <i>ROE_C</i>             | 210  | -0.1436476 | 0.9633046 | -5.982.058 | 5.141.513 |

Source: Authors' elaboration.

Table 2 summarises the descriptive statistics for 210 SME firm-year observations, highlighting key aspects of financial performance, risk, and governance. The average *Tobin's Q* of 1.38 indicates slight overvaluation among SMEs, while high variability in *EBITDA* and *FCF* shows differing profitability and liquidity conditions. The mean *DAR* of 3.63 reflects significant differences in leverage, and the negative average *ROE* (-0.14) suggests that many firms struggle with profitability. Liquidity also varies widely, with *CRs* ranging from almost zero to over 4, indicating that some firms maintain strong buffers while others face tight financial constraints. *RETA* (5.89) levels show that many SMEs rely heavily on internal financing. Governance indicators reveal notable diversity: 47.6% of firms have female leaders, and *INSTOWN* averages 75%, suggesting strong external oversight. Independent board representation (43.4%) aligns with governance standards, but board size varies substantially (0–5 members), reflecting differences in decision-making structures. Overall, the descriptive statistics illustrate the heterogeneous nature of SME financial conditions. Variations in leverage, liquidity, financial flexibility, and governance structures play a central role in shaping firm performance and risk exposure.

### 4.2. Financial flexibility, governance mechanisms, and SME performance and risk

Table 3 presents the regression results on how financial flexibility affects SME performance and risk. *FCF* has a negative, significant effect on *EBITDA*, suggesting that excess liquidity may reduce operational efficiency. *FCF* also increases earnings volatility, suggesting greater instability when internal funds are poorly managed. *RETA* strongly and positively influence firm valuation but also increase financial risk, as evidenced by higher leverage and greater profit volatility. This dual effect implies that retained earnings build market confidence while also encouraging aggressive growth strategies. Liquidity constraints, as reflected in the *CR*, are negatively associated with *EBITDA*, underscoring the importance of readily available working capital for operational stability. *AT* does not affect performance but significantly increases earnings volatility, indicating revenue instability in asset-intensive firms. Overall, the model's  $R^2$  values show strong explanatory power, particularly for risk-related outcomes.

**Table 3.** Financial flexibility, governance mechanisms, and SME performance and risk

| Variable         | Performance Tobin's Q | Performance EBITDA | Risk VoltEBITDA | Risk DAR |
|------------------|-----------------------|--------------------|-----------------|----------|
| FCF <sub>-</sub> | 0.015                 | -0.045**           | -0.001*         | 0.027    |
|                  | (0.012)               | (0.021)            | (0.000)         | (0.035)  |
| ATO              | -0.013                | -0.057             | 0.009***        | 0.104    |
|                  | (0.055)               | (0.094)            | (0.002)         | (0.156)  |
| SG&A             | -0.025                | -0.020             | 0.000           | 0.010    |
|                  | (0.018)               | (0.031)            | (0.001)         | (0.052)  |
| RETA             | 0.031***              | 0.011              | 0.001***        | 0.692*** |
|                  | (0.006)               | (0.010)            | (0.000)         | (0.016)  |
| FIRMSIZE_C       | -0.728***             | 0.659***           | -0.004*         | 0.319*   |
|                  | (0.061)               | (0.106)            | (0.002)         | (0.176)  |
| CR_C             | 0.004**               | -0.012***          | -0.000          | 0.001    |
|                  | (0.002)               | (0.003)            | (0.000)         | (0.005)  |
| ROE_C            | -0.126                | 0.292*             | -0.017***       | 0.103    |
|                  | (0.097)               | (0.168)            | (0.004)         | (0.278)  |
| Constant         | 19.021***             | 5.791**            | 0.108*          | -8.439*  |
|                  | (1.527)               | (2.637)            | (0.061)         | (4.367)  |
| Observations     | 210                   | 210                | 210             | 210      |
| R <sup>2</sup>   | 0.582                 | 0.296              | 0.482           | 0.946    |

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Source: Authors' elaboration.

#### 4.3. Corporate governance mechanisms, financial flexibility, and their impact on SME performance and risk

Table 4 analyses how governance shapes SME performance and risk. Larger boards and independent directors significantly increase firm valuation, indicating that stronger oversight enhances market confidence. In contrast, FMOB and INSTOWN are associated with lower Tobin's Q, suggesting structural bias or more conservative decision-making. Liquidity constraints continue to pressure operational performance, as shown by the negative effect of the CR on EBITDA. For risk,

an FMCEO is associated with slightly higher earnings volatility, possibly reflecting market scepticism or different strategic approaches. Meanwhile, board independence and INSTOWN do not significantly reduce volatility, implying that traditional governance mechanisms may not always stabilise risk. Firm size remains the strongest stabiliser, lowering both volatility and debt risk, while higher ROE also reduces financial turbulence. Overall, these results show that governance, leadership composition, and financial conditions jointly influence SME performance, with firm size and profitability serving as key protective factors.

**Table 4.** Corporate governance mechanisms, financial flexibility, and their impact on SME performance and risk

| Variable               | Performance Tobin's Q | Performance EBITDA | Risk VoltEBITDA | Risk DAR |
|------------------------|-----------------------|--------------------|-----------------|----------|
| FMCEO <sub>d</sub>     | -0.350                | 0.257              | 0.020*          | 3.731    |
|                        | (0.224)               | (0.357)            | (0.011)         | (2.456)  |
| FMOB <sub>-</sub>      | -0.510**              | 0.323              | 0.005           | 1.799    |
|                        | (0.222)               | (0.354)            | (0.011)         | (2.436)  |
| BoardSize <sub>M</sub> | 0.307**               | 0.074              | -0.000          | 2.344    |
|                        | (0.131)               | (0.209)            | (0.006)         | (1.441)  |
| IndepBoard             | 1.462**               | 1.832              | 0.028           | 8.342    |
|                        | (0.714)               | (1.138)            | (0.034)         | (7.840)  |
| INSTOWN <sub>M</sub>   | -0.156*               | 0.052              | 0.001           | 0.452    |
|                        | (0.090)               | (0.144)            | (0.004)         | (0.989)  |
| FIRMSIZE_C             | -0.802***             | 0.718***           | -0.008**        | -1.570** |
|                        | (0.063)               | (0.101)            | (0.003)         | (0.694)  |
| CR_C                   | 0.001                 | -0.011***          | -0.000          | -0.020   |
|                        | (0.002)               | (0.003)            | (0.000)         | (0.023)  |
| ROE_C                  | -0.089                | 0.285*             | -0.015***       | 0.664    |
|                        | (0.107)               | (0.170)            | (0.005)         | (1.170)  |
| Constant               | 20.177***             | 2.975              | 0.184**         | 30.261*  |
|                        | (1.587)               | (2.530)            | (0.077)         | (17.426) |
| Observations           | 210                   | 210                | 210             | 210      |
| R <sup>2</sup>         | 0.506                 | 0.291              | 0.093           | 0.064    |

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Source: Authors' elaboration.

#### 4.4. Moderating effects of financial flexibility on governance, SME performance, and risk

##### 4.4.1. Tobin's Q

Table 5 focuses on Tobin's Q, reveals that FMOB has an adverse effect (-0.741,  $p < 0.01$ ). However, its interaction with FCF has a positive impact on firm value (0.744,  $p < 0.01$ ), suggesting that gender diversity in leadership is more effective when firms

have financial flexibility. In addition, firm size negatively impacts Tobin's Q across all governance variables, reinforcing that larger SMEs face valuation challenges, likely due to market expectations or operational complexity. Meanwhile, board independence and INSTOWN show mixed effects, with independent boards increasing the impact of FCF on valuation (0.821,  $p < 0.01$ ), suggesting that strong governance strengthens financial efficiency.

**Table 5.** Moderating role of financial flexibility in governance-performance relationship (Tobin's Q)

| <i>Variable</i>           | <i>FMoB</i><br>(1)   | <i>FMCEO</i><br>(2)  | <i>BoardSize</i><br>(3) | <i>IndepBoard</i><br>(4) | <i>INSTOWN</i><br>(5) |
|---------------------------|----------------------|----------------------|-------------------------|--------------------------|-----------------------|
| <i>FCF_</i>               | 0.018<br>(0.012)     | 0.015<br>(0.012)     | -0.908***<br>(0.261)    | -0.523***<br>(0.127)     | -0.016<br>(0.105)     |
| <i>ATO</i>                | 0.249<br>(0.154)     | -0.318**<br>(0.153)  | -0.541<br>(0.457)       | 0.205<br>(0.230)         | -0.132<br>(0.283)     |
| <i>SG&amp;A</i>           | -0.024<br>(0.018)    | -0.025<br>(0.048)    | 0.036<br>(0.202)        | 0.301*<br>(0.173)        | 0.099<br>(0.079)      |
| <i>RETA</i>               | 0.033***<br>(0.012)  | 0.077***<br>(0.012)  | -0.106<br>(0.119)       | -0.006<br>(0.090)        | 0.151***<br>(0.045)   |
| <i>FMoB_</i>              | -0.741***<br>(0.239) |                      |                         |                          |                       |
| <i>FCF_FMoB</i>           | 0.744***<br>(0.173)  |                      |                         |                          |                       |
| <i>ATO_FMoB</i>           | -0.262<br>(0.164)    |                      |                         |                          |                       |
| <i>RatioSGA_FMoB</i>      | 0.033<br>(0.051)     |                      |                         |                          |                       |
| <i>RETA_FMoB</i>          | -0.008<br>(0.014)    |                      |                         |                          |                       |
| <i>FIRMSIZE_C</i>         | -0.666***<br>(0.062) | -0.721***<br>(0.062) | -0.671***<br>(0.064)    | -0.642***<br>(0.063)     | -0.602***<br>(0.073)  |
| <i>CR_C</i>               | 0.004**<br>(0.002)   | 0.004**<br>(0.002)   | 0.004*<br>(0.002)       | 0.004**<br>(0.002)       | 0.004**<br>(0.002)    |
| <i>ROE_C</i>              | -0.146<br>(0.091)    | -0.122<br>(0.092)    | -0.167*<br>(0.098)      | -0.176*<br>(0.096)       | -0.130<br>(0.095)     |
| <i>FMCEO_d</i>            |                      | -0.061<br>(0.234)    |                         |                          |                       |
| <i>FCF_FMCEO</i>          |                      | -0.157*<br>(0.090)   |                         |                          |                       |
| <i>ATO_FMCEO</i>          |                      | 0.351**<br>(0.163)   |                         |                          |                       |
| <i>RatioSGA_FMCEO</i>     |                      | -0.003<br>(0.052)    |                         |                          |                       |
| <i>RETA_FMCEO</i>         |                      | -0.061***<br>(0.013) |                         |                          |                       |
| <i>BoardSize_M</i>        |                      |                      | -0.290<br>(0.197)       |                          |                       |
| <i>FCF_BoardSize</i>      |                      |                      | 0.464***<br>(0.131)     |                          |                       |
| <i>ATO_BoardSize</i>      |                      |                      | 0.175<br>(0.157)        |                          |                       |
| <i>RatioSGA_BoardSize</i> |                      |                      | -0.030<br>(0.100)       |                          |                       |
| <i>RETA_BoardSize</i>     |                      |                      | 0.046<br>(0.040)        |                          |                       |
| <i>IndepBoard</i>         |                      |                      |                         | 0.805<br>(0.777)         |                       |
| <i>FCF_IndepBoard</i>     |                      |                      |                         | 0.821***<br>(0.193)      |                       |
| <i>ATO_IndepBoard</i>     |                      |                      |                         | -0.154<br>(0.160)        |                       |
| <i>SGA_IndepBoard</i>     |                      |                      |                         | -0.317*<br>(0.171)       |                       |
| <i>RETA_IndepBoard</i>    |                      |                      |                         | 0.025<br>(0.060)         |                       |
| <i>INSTOWN_M</i>          |                      |                      |                         |                          | -0.128<br>(0.255)     |
| <i>FCF_INSTOWN</i>        |                      |                      |                         |                          | 0.082<br>(0.207)      |
| <i>ATO_INSTOWN</i>        |                      |                      |                         |                          | 0.143<br>(0.327)      |
| <i>SGA_INSTOWN</i>        |                      |                      |                         |                          | -0.240<br>(0.151)     |
| <i>RETA_INSTOWN</i>       |                      |                      |                         |                          | -0.132***<br>(0.050)  |
| Constant                  | 17.480***<br>(1.554) | 18.959***<br>(1.511) | 18.251***<br>(1.551)    | 16.252***<br>(1.623)     | 15.947***<br>(1.857)  |
| Observations              | 210                  | 210                  | 210                     | 210                      | 210                   |
| R <sup>2</sup>            | 0.652                | 0.638                | 0.610                   | 0.625                    | 0.614                 |

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Source: Authors' elaboration.

#### 4.4.2. EBITDA

Table 6 examines EBITDA, highlights a different dynamic: while FMoBs exhibit a negative direct effect on performance (-0.250), their interaction with FCF significantly increases EBITDA (1.034,  $p < 0.01$ ),

reaffirming that female leadership strengthens operational profitability when supported by financial resources. Interestingly, independent boards also play an important role in moderating conflict, as evidenced by their positive association with FCF (0.703,  $p < 0.05$ ), suggesting that well-

managed firms utilise financial resources more effectively to improve profitability. However, liquidity constraints remain a challenge, with CR\_C consistently showing a negative impact on EBITDA (-0.011,  $p < 0.01$ ), underscoring the balance between financial management and operational performance.

Together, these findings emphasise that the effectiveness of governance structures depends on financial conditions, with strong leadership and oversight maximising firm performance when liquidity and cash flow are well managed.

**Table 6.** Moderating role of financial flexibility in governance-performance relationship (EBITDA)

| Variable           | FMoB (1)             | FMCEO (2)            | BoardSize (3)        | IndepBoard (4)       | INSTOWN (5)          |
|--------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| FCF_               | -0.035*<br>(0.021)   | -0.043**<br>(0.022)  | -0.568<br>(0.458)    | -0.496**<br>(0.225)  | 0.124<br>(0.186)     |
| RASIOATATO         | 0.167<br>(0.282)     | -0.173<br>(0.282)    | 0.430<br>(0.802)     | 0.617<br>(0.407)     | 0.679<br>(0.501)     |
| RASIOSGA           | -0.005<br>(0.033)    | -0.050<br>(0.089)    | 0.026<br>(0.355)     | -0.043<br>(0.306)    | 0.056<br>(0.140)     |
| RETA               | 0.010<br>(0.023)     | 0.032<br>(0.021)     | 0.035<br>(0.209)     | 0.082<br>(0.159)     | 0.118<br>(0.079)     |
| FMoB_              | -0.250<br>(0.436)    |                      |                      |                      |                      |
| FCF_FMoB           | 1.034***<br>(0.316)  |                      |                      |                      |                      |
| ATO_FMoB           | -0.231<br>(0.299)    |                      |                      |                      |                      |
| RatioSGA_FMoB      | -0.024<br>(0.094)    |                      |                      |                      |                      |
| RETA_FMoB          | -0.002<br>(0.025)    |                      |                      |                      |                      |
| FIRMSIZE_C         | 0.788***<br>(0.113)  | 0.639***<br>(0.115)  | 0.723***<br>(0.112)  | 0.786***<br>(0.112)  | 0.790***<br>(0.130)  |
| CR_C               | -0.011***<br>(0.003) | -0.011***<br>(0.003) | -0.012***<br>(0.003) | -0.012***<br>(0.003) | -0.011***<br>(0.003) |
| ROE_C              | 0.230<br>(0.166)     | 0.314*<br>(0.170)    | 0.283<br>(0.172)     | 0.266<br>(0.169)     | 0.289*<br>(0.168)    |
| FMCEO_d            |                      | 0.352<br>(0.430)     |                      |                      |                      |
| FCF_FMCEO          |                      | -0.146<br>(0.166)    |                      |                      |                      |
| ATO_FMCEO          |                      | 0.130<br>(0.300)     |                      |                      |                      |
| RatioSGA_FMCEO     |                      | 0.030<br>(0.095)     |                      |                      |                      |
| RETA_FMCEO         |                      | -0.029<br>(0.024)    |                      |                      |                      |
| BoardSize_M        |                      |                      | 0.100<br>(0.346)     |                      |                      |
| FCF_BoardSize      |                      |                      | 0.267<br>(0.230)     |                      |                      |
| ATO_BoardSize      |                      |                      | -0.179<br>(0.276)    |                      |                      |
| RatioSGA_BoardSize |                      |                      | -0.019<br>(0.175)    |                      |                      |
| RETA_BoardSize     |                      |                      | -0.007<br>(0.070)    |                      |                      |
| IndepBoard         |                      |                      |                      | 1.818<br>(1.375)     |                      |
| FCF_IndepBoard     |                      |                      |                      | 0.703**<br>(0.340)   |                      |
| ATO_IndepBoard     |                      |                      |                      | -0.487*<br>(0.284)   |                      |
| SGA_IndepBoard     |                      |                      |                      | 0.033<br>(0.302)     |                      |
| RETA_IndepBoard    |                      |                      |                      | -0.045<br>(0.106)    |                      |
| INSTOWN_M          |                      |                      |                      |                      | 0.665<br>(0.451)     |
| FCF_INSTOWN        |                      |                      |                      |                      | -0.306<br>(0.367)    |
| ATO_INSTOWN        |                      |                      |                      |                      | -0.864<br>(0.579)    |
| SGA_INSTOWN        |                      |                      |                      |                      | -0.129<br>(0.267)    |
| RETA_INSTOWN       |                      |                      |                      |                      | -0.113<br>(0.088)    |
| Constant           | 2.292<br>(2.843)     | 6.185**<br>(2.778)   | 3.808<br>(2.720)     | 1.503<br>(2.871)     | 1.954<br>(3.284)     |
| Observations       | 210                  | 210                  | 210                  | 210                  | 210                  |
| R <sup>2</sup>     | 0.343                | 0.309                | 0.323                | 0.338                | 0.319                |

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .  
Source: Authors' elaboration.

#### 4.5. The interaction between financial flexibility, governance, and risk management in SMEs

##### 4.5.1. Moderating effects of financial flexibility on SME earnings volatility

Table 7 examines EBITDA volatility, reveals that firm size (FIRMSIZE\_C) and profitability (ROE\_C) consistently reduce financial volatility ( $p < 0.05$ ), reinforcing that larger and more profitable firms experience more stable earnings. However, AT (RASIOATATO) significantly increases volatility ( $p < 0.01$ ), suggesting that high asset utilisation may

lead to financial instability. Interestingly, the presence of FMoB slightly increases volatility (0.017,  $p < 0.1$ ), but its interaction with RETA (RETA\_FMoB) has a stabilising effect (0.002,  $p < 0.01$ ). This suggests that gender-diverse boards may initially introduce variability, but when combined with a firm's retained earnings policy, they help stabilise financial performance. Meanwhile, INSTOWN reduces risk when interacting with FCF (FCF\_INSTOWN = 0.024,  $p < 0.01$ ), emphasising the role of institutional investors in improving financial discipline.

**Table 7.** Moderating effects of financial flexibility on SME earnings volatility

| Variable           | FMoB<br>(1)          | FMCEO<br>(2)         | BoardSize<br>(3)     | IndepBoard<br>(4)    | INSTOWN<br>(5)       |
|--------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| FCF_               | -0.001<br>(0.000)    | -0.000<br>(0.000)    | -0.015*<br>(0.009)   | -0.003<br>(0.005)    | -0.012***<br>(0.004) |
| RASIOATATO         | 0.037***<br>(0.006)  | 0.007<br>(0.005)     | 0.048***<br>(0.015)  | 0.021***<br>(0.008)  | 0.036***<br>(0.010)  |
| RASIOSGA           | 0.001<br>(0.001)     | 0.000<br>(0.002)     | 0.003<br>(0.007)     | 0.003<br>(0.006)     | 0.001<br>(0.003)     |
| RETA               | -0.001<br>(0.001)    | 0.001***<br>(0.000)  | 0.013***<br>(0.004)  | 0.022***<br>(0.003)  | 0.005***<br>(0.002)  |
| FMoB_              | 0.017*<br>(0.010)    |                      |                      |                      |                      |
| FCF_FMoB           | -0.009<br>(0.007)    |                      |                      |                      |                      |
| ATO_FMoB           | -0.031***<br>(0.007) |                      |                      |                      |                      |
| RatioSGA_FMoB      | -0.001<br>(0.002)    |                      |                      |                      |                      |
| RETA_FMoB          | 0.002***<br>(0.001)  |                      |                      |                      |                      |
| FIRMSIZE_C         | -0.005*<br>(0.003)   | -0.001<br>(0.002)    | 0.001<br>(0.002)     | 0.000<br>(0.002)     | -0.001<br>(0.003)    |
| CR_C               | -0.000<br>(0.000)    | 0.000<br>(0.000)     | -0.000<br>(0.000)    | -0.000<br>(0.000)    | 0.000<br>(0.000)     |
| ROE_C              | -0.016***<br>(0.004) | -0.014***<br>(0.003) | -0.014***<br>(0.003) | -0.013***<br>(0.003) | -0.015***<br>(0.003) |
| FMCEO_d            |                      | 0.022***<br>(0.008)  |                      |                      |                      |
| FCF_FMCEO          |                      | -0.031***<br>(0.003) |                      |                      |                      |
| ATO_FMCEO          |                      | -0.000<br>(0.006)    |                      |                      |                      |
| RatioSGA_FMCEO     |                      | -0.000<br>(0.002)    |                      |                      |                      |
| RETA_FMCEO         |                      | 0.000<br>(0.000)     |                      |                      |                      |
| BoardSize_M        |                      |                      | 0.002<br>(0.007)     |                      |                      |
| FCF_BoardSize      |                      |                      | 0.008*<br>(0.004)    |                      |                      |
| ATO_BoardSize      |                      |                      | -0.014***<br>(0.005) |                      |                      |
| RatioSGA_BoardSize |                      |                      | -0.001<br>(0.003)    |                      |                      |
| RETA_BoardSize     |                      |                      | -0.004***<br>(0.001) |                      |                      |
| IndepBoard         |                      |                      |                      | 0.032<br>(0.028)     |                      |
| FCF_IndepBoard     |                      |                      |                      | 0.005<br>(0.007)     |                      |
| ATO_IndepBoard     |                      |                      |                      | -0.010*<br>(0.006)   |                      |
| SGA_IndepBoard     |                      |                      |                      | -0.002<br>(0.006)    |                      |
| RETA_IndepBoard    |                      |                      |                      | -0.014***<br>(0.002) |                      |
| INSTOWN_M          |                      |                      |                      |                      | -0.003<br>(0.009)    |
| FCF_INSTOWN        |                      |                      |                      |                      | 0.024***<br>(0.007)  |
| ATO_INSTOWN        |                      |                      |                      |                      | -0.034***<br>(0.011) |
| SGA_INSTOWN        |                      |                      |                      |                      | -0.002<br>(0.005)    |
| RETA_INSTOWN       |                      |                      |                      |                      | -0.004**<br>(0.002)  |
| Constant           | 0.105<br>(0.064)     | 0.036<br>(0.052)     | -0.024<br>(0.052)    | -0.028<br>(0.058)    | 0.012<br>(0.064)     |
| Observations       | 210                  | 210                  | 210                  | 210                  | 210                  |
| R <sup>2</sup>     | 0.536                | 0.664                | 0.655                | 0.630                | 0.635                |

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .  
Source: Authors' elaboration.

#### 4.5.2. The role of financial flexibility and governance in SME debt risk management

Table 8 focuses on DAR and provides further insight into the role of governance in financial stability. FMoB is associated with higher DAR (1.627,  $p < 0.01$ ). However, its interaction with FCF (FCF\_FMoB) significantly lowers risk (-1.987,  $p < 0.01$ ), suggesting that female-led firms manage debt more effectively when financial resources are available. Similarly, having a female CEO (FMCEO) directly lowers debt risk (-0.937,  $p < 0.01$ ), suggesting that women in top leadership positions adopt more conservative financial strategies. However, BoardSize

increases debt risk, especially when interacting with AT (ATO\_BoardSize = -1.500,  $p < 0.01$ ), suggesting that firms with more directors may struggle with financial control in a highly operational environment. Interestingly, INSTOWN stabilises debt risk only when combined with high RETA (RETA\_INSTOWN = 0.641,  $p < 0.01$ ), reinforcing the importance of long-term financial reserves in mitigating leverage-related challenges. These findings underscore that effective governance can both mitigate and exacerbate risk depending on financial conditions, highlighting the critical role of financial policies and leadership strategies in ensuring SME stability.

**Table 8.** The role of financial flexibility and governance in SME debt risk management (Part 1)

| Variable           | FMoB<br>(1)          | FMCEO<br>(2)         | BoardSize<br>(3)     | IndepBoard<br>(4)   | INSTOWN<br>(5)    |
|--------------------|----------------------|----------------------|----------------------|---------------------|-------------------|
| FCF_               | 0.041***<br>(0.012)  | 0.037**<br>(0.016)   | 1.864**<br>(0.717)   | 1.588***<br>(0.349) | 0.123<br>(0.297)  |
| RASIOATATO         | 0.418***<br>(0.160)  | 0.267<br>(0.213)     | 4.504***<br>(1.255)  | 0.945<br>(0.630)    | 1.406*<br>(0.800) |
| RASIOSGA           | 0.016<br>(0.019)     | -0.018<br>(0.067)    | 0.367<br>(0.556)     | -0.146<br>(0.473)   | -0.010<br>(0.223) |
| RETA               | 0.453***<br>(0.013)  | 0.463***<br>(0.016)  | -0.450<br>(0.327)    | -0.273<br>(0.246)   | 0.118<br>(0.126)  |
| FMoB_              | 1.627***<br>(0.247)  |                      |                      |                     |                   |
| FCF_FMoB           | -1.987***<br>(0.179) |                      |                      |                     |                   |
| ATO_FMoB           | -0.498***<br>(0.170) |                      |                      |                     |                   |
| RatioSGA_FMoB      | -0.092*<br>(0.053)   |                      |                      |                     |                   |
| RETA_FMoB          | 0.346***<br>(0.014)  |                      |                      |                     |                   |
| FIRMSIZE_C         | 0.427***<br>(0.064)  | 0.515***<br>(0.087)  | 0.107<br>(0.175)     | -0.051<br>(0.173)   | -0.201<br>(0.207) |
| CR_C               | 0.001<br>(0.002)     | -0.000<br>(0.003)    | 0.004<br>(0.005)     | 0.003<br>(0.005)    | 0.000<br>(0.005)  |
| ROE_C              | 0.057<br>(0.094)     | 0.101<br>(0.128)     | -0.041<br>(0.269)    | 0.103<br>(0.262)    | 0.145<br>(0.269)  |
| FMCEO_d            |                      | -0.937***<br>(0.324) |                      |                     |                   |
| FCF_FMCEO          |                      | 0.458***<br>(0.125)  |                      |                     |                   |
| ATO_FMCEO          |                      | -0.308<br>(0.226)    |                      |                     |                   |
| RatioSGA_FMCEO     |                      | 0.041<br>(0.072)     |                      |                     |                   |
| RETA_FMCEO         |                      | 0.339***<br>(0.018)  |                      |                     |                   |
| BoardSize_M        |                      |                      | 0.890<br>(0.541)     |                     |                   |
| FCF_BoardSize      |                      |                      | -0.930**<br>(0.359)  |                     |                   |
| ATO_BoardSize      |                      |                      | -1.500***<br>(0.432) |                     |                   |
| RatioSGA_BoardSize |                      |                      | -0.172<br>(0.273)    |                     |                   |
| RETA_BoardSize     |                      |                      | 0.384***<br>(0.110)  |                     |                   |

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Source: Authors' elaboration.

**Table 8.** The role of financial flexibility and governance in SME debt risk management (Part 2)

| Variable        | FMoB<br>(1)           | FMCEO<br>(2)          | BoardSize<br>(3)  | IndepBoard<br>(4)    | INSTOWN<br>(5)      |
|-----------------|-----------------------|-----------------------|-------------------|----------------------|---------------------|
| IndepBoard      |                       |                       |                   | 2.396<br>(2.128)     |                     |
| FCF_IndepBoard  |                       |                       |                   | -2.400***<br>(0.527) |                     |
| ATO_IndepBoard  |                       |                       |                   | -0.567<br>(0.439)    |                     |
| SGA_IndepBoard  |                       |                       |                   | 0.130<br>(0.467)     |                     |
| RETA_IndepBoard |                       |                       |                   | 0.647***<br>(0.165)  |                     |
| INSTOWN_M       |                       |                       |                   |                      | 0.573<br>(0.720)    |
| FCF_INSTOWN     |                       |                       |                   |                      | -0.273<br>(0.586)   |
| ATO_INSTOWN     |                       |                       |                   |                      | -1.588*<br>(0.926)  |
| SGA_INSTOWN     |                       |                       |                   |                      | 0.024<br>(0.426)    |
| RETA_INSTOWN    |                       |                       |                   |                      | 0.641***<br>(0.140) |
| Constant        | -10.942***<br>(1.611) | -12.688***<br>(2.098) | -5.255<br>(4.257) | 0.468<br>(4.444)     | 4.257<br>(5.249)    |
| Observations    | 210                   | 210                   | 210               | 210                  | 210                 |
| R <sup>2</sup>  | 0.994                 | 0.989                 | 0.954             | 0.956                | 0.952               |

Note: Standard errors in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ .

Source: Authors' elaboration.

## 5. DISCUSSION

The empirical findings strongly support *H1*, showing that free cash flow negatively affects EBITDA, indicating that excess liquidity leads to inefficiency in SMEs. This aligns with agency theory, which holds that managers may misuse unallocated internal cash. Free cash flow also increases earnings volatility, reinforcing the risk of agency-driven misallocation. Firm size shows a negative effect on Tobin's Q but a positive effect on EBITDA, suggesting that larger firms gain efficiency through economies of scale but may lose market valuation due to complexity and declining agility consistent with the entropy hypothesis (Demsetz & Lehn, 1985). *H2* is supported, as retained earnings to total assets (RETA) are shown to significantly improve firm valuation. However, RETA also increases leverage and earnings volatility, indicating a dual effect: while it strengthens market confidence, it also encourages risk-taking. This is consistent with findings that retained earnings act as "quiet capital", enhancing credibility while potentially funding aggressive expansion (Hutabarat et al., 2025). Evidence for *H3* shows that liquidity constraints, measured by the current ratio (CR\_C), reduce EBITDA.

Regarding governance, *H4* is confirmed: independent boards increase valuation but do not significantly affect EBITDA. This reflects the role of independent directors as signals of investor confidence rather than internal efficiency drivers (Abdel-Aziz & Alrabba, 2023). *H5* reveals that female board representation initially reduces valuation (possibly due to market bias) but improves performance when financial flexibility is high. Interaction effects show that  $FMoB \times FCF$  boosts EBITDA, supporting research that financial resources enable women leaders to enhance operational outcomes (Shaheen et al., 2023). A mixed-effects model of institutional ownership supports *H6*. While institutional investors decrease Tobin's Q, reflecting cautious monitoring, they reduce debt risk when

combined with high RETA. This aligns with agency theory and resource dependency theory, showing institutions are more effective when firms possess internal buffers (Kasbar et al., 2023; Liu & Hou, 2023).

For financial risk, *H7* is confirmed: higher asset turnover increases earnings volatility, indicating instability in revenue flows. Prior research similarly notes that rapid asset utilisation increases profit fluctuations, especially in the absence of adequate risk governance (Arora & Gupta, 2023). *H8* shows that female CEOs reduce debt risk but slightly increase earnings volatility. This aligns with evidence that women leaders adopt conservative debt strategies but may face market scepticism, which can lead to short-term volatility (Sila et al., 2016; Batra et al., 2025). The analysis of *H9* indicates that larger boards increase debt risk, consistent with agency theory's view of coordination problems in oversized boards (Lipton & Lorsch, 1992). However, board size interacts with free cash flow and asset turnover, reducing risk, suggesting that boards become more effective when supported by strong cash flow and asset efficiency. Evidence for *H10* indicates that independent, gender-diverse boards enhance performance when financial flexibility is high. Interaction terms ( $FMoB \times FCF$ ;  $IndepBoard \times FCF$ ) significantly improve valuation and profitability. This supports findings that gender-diverse governance yields conditional benefits depending on financial strength (Garcia Martin & Herrero, 2020). Finally, *H11* is supported: independent boards reduce earnings volatility, and institutional ownership stabilises risk when firms possess adequate liquidity. This is consistent with the literature, which emphasises engaged stewardship and governance quality for risk mitigation (Kim & Lu, 2013).

Overall, these results demonstrate that governance effectiveness is not universal; it is highly contingent upon financial flexibility, liquidity conditions, and internal capital strength. Effective governance requires alignment between board

structure, ownership composition, and the firm's financial capacity. Governance mechanisms, particularly independence, gender diversity, and institutional monitoring, yield the greatest benefits when firms have the liquidity and retained earnings to implement strategic recommendations. Thus, SMEs must not rely on static governance structures but adapt them according to financial conditions and risk profiles to enhance performance and stability.

## 6. CONCLUSION

This study provides empirical evidence from an emerging-market context on the interplay among corporate governance, financial flexibility, and SME performance. The findings challenge the universal applicability of traditional governance mechanisms, demonstrating that their effectiveness depends on the firm's financial flexibility. Specifically, we find that while independent boards improve firm valuation, their impact on operational profitability is limited unless supported by adequate liquidity. Furthermore, gender diversity on boards initially faces valuation challenges but significantly enhances operational efficiency and reduces debt risk when firms maintain high financial flexibility, such as strong retained earnings. Institutional ownership acts as a double-edged sword; it may lower valuation due to risk aversion, but it successfully mitigates financial risk when combined with solid internal capital buffers.

Theoretically, this research advances the integration of agency theory and resource dependency theory by establishing financial

flexibility not only as a resource but also as a critical moderator that enhances governance effectiveness. Practically, the results imply that SME owners and managers should not view governance structures in isolation. Instead, they must align board composition and ownership structures with their liquidity management strategies. For policymakers in emerging markets, the study suggests that regulations promoting good governance (such as board independence or gender quotas) should be accompanied by initiatives that support SME liquidity and capital accumulation, such as tax incentives for retained earnings or easier access to working capital.

Despite its contributions, this study has limitations. First, the sample is restricted to SMEs listed on the IDX, which may not fully represent the vast number of unlisted or micro-enterprises operating in the informal sector. Second, the observation period (2019–2023) includes the COVID-19 pandemic, which might have introduced unique volatility anomalies, although this also provides a stress-test perspective. Future research should either expand the scope to include unlisted SMEs or conduct comparative studies across different emerging economies to validate these findings. Additionally, researchers could explore alternative methodologies, such as qualitative approaches or GMM, to further investigate the behavioural aspects of board decision-making under financial distress. Investigating the specific types of “financial flexibility” (e.g., access to bank lines of credit vs. cash holdings) could yield more granular insights into financial management strategies.

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