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Should CFOs Serve on Other Companies Boards?



Should CFOs serve on boards of directors of outside companies? Relatively few do so: one survey by a leading headhunter found that only about 7% of CFOs of the Fortune 500 serve on boards of other Fortune-500 firms. As a new study notes, this probably reflects concerns about the amount of time board service entails, concerns that "are exacerbated when one considers that a CFO who serves on an outside board is likely to be a member of the audit committee, which is one of the most demanding and time-consuming committees."

Notwithstanding such doubts, the new paper concludes that, far from interfering with CFOs' provision of sound financial reporting for their home firms, service on outside boards actually enhances it. In the words of the study in the December issue of *Accounting Horizons*, a peer-reviewed journal of the [American Accounting Association](#), "Directorships are valuable resources for learning and networking and thus can help reduce financial misstatements of the home firm."

Moreover, the enhancement in accounting quality is considerable, according to the author of the new research, Sarfraz Khan, an associate professor of accounting at the

University of Louisiana at Lafayette. Comparing financial reporting of two groups of similar firms whose CFOs either serve as outside directors or do not, the professor finds 21% fewer misstatements of financial results in the former group than in the latter. Misstatements can result in such negative consequences for companies as lowered stock price, increased incidence of litigation, and raised cost of capital.

"Firms should encourage, not restrict, their CFOs from joining outside boards," Prof. Khan concludes. Not only will this benefit CFOs' home companies, he adds, but it may help alleviate reported difficulties firms have experienced in recruiting financially expert directors, shortages that have led some firms to reduce board sizes and extend directors' retirement ages.

What accounts for the superior results from outside board service? "CFOs interact with other directors, thus enriching their own knowledge and experience beyond what they can learn at their home firm," Prof. Khan writes. They "can gain problem-solving expertise...to better discharge their fiduciary responsibilities and resolve issues at the source firm...By serving on external audit committees, CFOs gain greater accounting-related expertise...Overall, the results suggest that outside directorships connect CFOs to other executives and directors who can be sources of counsel and insight."

The study draws on data involving 3,741 firms during a 12-year period. In an average year, about 8% of CFOs served as directors of outside firms. On average 14% of companies – but only 11% of the firms whose CFOs served as outside directors – issued restatements of prior misreportings.

A major challenge of the research was in probing whether the superior results that the professor found to be associated with outside directorships are attributable specifically to this outside service. After all, the offering of directorships to CFOs by outside companies seems likely to reflect the recruitment boost CFOs get from the superior management of their home firms. As Prof. Khan explains, "Recruiting firms are likely to use information cues from CFOs' home firms to determine CFOs' potential contribution to the hiring board [and to consider] the reputation and prestige of the home firm." Thus, this question: Isn't the financial reporting of the home firm of a CFO outside director likely to be superior independently of their experience in serving on an outside board?

In probing this, Prof. Khan makes use of prior accounting research that provides means of measuring the quality of firms' financial management, a variable he labels "managerial ability." Taking this variable and many other factors into account, he carries out two principal analyses:

The first compares the financial reporting of firms whose CFOs serve on outside boards with that of similar firms whose CFOs do not. As indicated above, the professor finds significantly higher financial-reporting quality in the former group

The second analysis probes how factors associated with the recruitment of CFOs to outside boards relate to their home firms' financial-reporting quality. It reveals that, while managerial ability contributes significantly to CFOs' being recruited to outside boards, so do a number of other factors. Notable among these is the density of companies in a geographic area, which earlier research has found to influence supply and demand in the director labor market. And, indeed, the new study finds density to be at least as important as managerial ability in contributing to CFOs' recruitment to outside boards.

How, then, do CFOs' outside directorships improve home-firm financial reporting? Density has no bearing on it, analysis reveals, and when the outside directorships are weighed as a factor, managerial ability is only weakly associated with superior reporting. In fact, no single factor among many considered is significantly associated with both CFO recruitment to outside boards and superior reporting. Something else, then, accounts for the considerable enhancement in reporting quality associated with outside directorships, and that something else, the study concludes, has to be the experience itself.

In short, the effect of this experience is above and beyond that of managerial ability.

Or, as Prof. Khan comments, "The results can be summarized by two affirmatives: yes, CFOs recruited to outside directorships tend to come from well-managed companies and, yes, what CFOs gain from serving as outside directors improves the management of their home firms even further."

The paper, "CFO Outside Directorship and Financial Misstatements," is in the December issue of ***Accounting Horizons***, a peer-reviewed journal published quarterly by the ***American Accounting Association***, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *The Accounting Review*, *Auditing: A Journal of Practice and Theory*, *Issues in Accounting Education*, *Behavioral Research in Accounting*, *Journal of Management Accounting Research*, *Journal of Information Systems*, *Journal of Financial Reporting*, *The Journal of the American Taxation Association*, and *Journal of Forensic Accounting Research*.