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Outside Board Service Boosts Inside Accounting Quality

CFOs who serve on other companies' boards make significantly fewer errors in their own financial reporting.

By David McCann

Few CFOs serve on **boards of directors of outside companies**. That probably reflects concerns about the amount of time board service entails, according to a new study, especially since a majority of **finance chiefs on outside boards** are members of the time-consuming audit committees.

Yet the study concluded that, far from interfering with CFOs' ability to provide sound financial reporting for their employers, service on outside boards actually enhances it.

“Directorships are valuable resources for learning and networking and thus can help reduce financial misstatements of the home firm,” said the study report, published in the December issue of ***Accounting Horizons*,** a peer-reviewed journal of the **American Accounting Association**.

In fact, the enhancement in accounting quality is considerable. Comparing the financial reporting of two groups of similar companies whose CFOs either served as outside directors or did not, the study found 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 higher cost of capital.

“Firms should encourage, not restrict, their CFOs from joining outside boards,” says the study’s author, Sarfraz Khan, an associate professor of accounting at the University of Louisiana at Lafayette

Not only will that benefit the finance chiefs’ companies, he adds, it also may help alleviate difficulties companies have experienced in recruiting financially expert directors. Such shortages that have led some firms to reduce board sizes and extend directors’ retirement ages.

What accounts for the study finding?

“CFOs interact with other directors, thus enriching their own knowledge and experience beyond what they can learn at their home firm,” Khan wrote. They “can gain problem-solving expertise … to better discharge their fiduciary responsibilities and resolve issues.”

And by serving on external audit committees, CFOs gain greater accounting 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 report said.

The study drew on data for 3,741 companies 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 those whose CFOs served as outside directors — issued restatements of prior misreportings.

A major challenge of the research was determining whether the superior results associated with outside directorships were attributable specifically to that factor. After all, CFOs from well-managed companies are probably more likely to be recruited for outside directorships.

Khan made use of prior accounting research providing means of measuring the quality of companies’ financial management, a variable he labeled “managerial ability.” Taking that and many other factors into account, he carried out two principal analyses.

The first compared the financial reporting of companies whose CFOs served on outside boards with that of similar firms whose CFOs did not. As indicated above, the professor found significantly higher financial-reporting quality in the former group.

The second analysis probed how factors associated with the recruitment of CFOs to outside boards related to their companies' financial-reporting quality. It revealed that, while managerial ability contributed significantly to CFOs' being recruited to outside boards, so did a number of other factors.

Notable among those was the density of companies in a geographic area, which earlier research had found to influence supply and demand in the director market. Indeed, the new study found such density to be at least as important as managerial ability in contributing to CFOs' recruitment to outside boards.

How, then, did CFOs' outside directorships improve home-firm financial reporting? Density had no bearing on it, analysis revealed, and managerial ability was only weakly associated with superior reporting.

In fact, no single factor among the many considered was significantly associated with both CFO recruitment to outside boards and superior reporting.

Something else, then, accounted for the considerable enhancement in reporting quality associated with outside directorships — and that something else, the study concluded, has to be the experience itself.

"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," said Khan.