Blog: Should CFOs serve on outside boards?

By Cydney Posner | Cooley LLP

When a company’s CFO serves on another company’s board, does it help or hurt the financial reporting of the CFO’s company? It’s easy to imagine that the time commitment associated with outside board service would be a distraction from the CFO’s primary job and ultimately impair the CFO’s performance—especially since, as reported in CFO.com, a majority of finance chiefs on outside boards are appointed to the time-consuming audit committee. But, according to an academic study, “CFO Outside Directorship and Financial Misstatements,” just published in Accounting Horizons, a peer-reviewed journal of the American Accounting Association (link is to a version on SSRN), that’s not the case. In fact, the study demonstrated that outside board service can actually enhance the quality of the financial reporting of the CFO’s company.

Although CFOs are primary candidates for the post of financial expert on audit committees, few CFOs currently serve on boards. One reason may be that, according to the study, about 60% of large companies do not allow their CFOs to serve on outside boards, due at least in part to the significant time commitment associated with audit committee service. But, the study contends, outside board service can also benefit the CFO’s company:
“First, serving on an outside board gives CFOs insight into board dynamics and makes them better communicators with their home firms’ directors. Improved communication makes these CFOs more influential at their home firms, as they can articulate their messages and policies more clearly to the board. Second, most CFOs on outside boards are likely to serve on the audit committee, which can provide valuable experience and learning opportunities related to their role at the home firm. CFOs can compare the accounting policies and practices of various firms and determine whether and why they differ. Based on this information, they can improve practices at the home firm.”

As a result, the author posits, more “knowledgeable and resourceful CFOs are more likely to correctly apply complex accounting standards and less likely to make material reporting errors. Thus benefits gained from outside directorships should reduce the likelihood of financial misstatements.” Of course, another possibility suggested is that the CFOs with the best reputations (and better accounting practices) are the ones that are invited to join outside boards. (Although the author designed his study to control for this and other factors, such as CFO idiosyncratic style, as causes of enhanced performance in the study results, it could not be ruled out entirely.)

The study was based on 22,053 firm-year observations of 3,741 firms for the years 2003 to 2014. In the sample, 8% of companies had CFOs who held outside board seats. The author concluded that “firms with CFOs holding outside directorships have a lower likelihood of restatements,” and that the data were statistically significant. In addition, companies with CFOs on outside boards had lower “sales volatility, operating cash-flow volatility, and percentage of losses,” as well as better “managerial ability.” Comparing groups of “matched companies” where one group had CFOs serving on outside boards and one group did not, the study showed “that the probability of CFO director firm restating is 21%…less than the corresponding matched firm.” In addition, the author found that “CFO outside directorships are associated with about 2% to 3% reduction in financial misstatements, given an unconditional probability of about 14%.”

Of course, restatements can have a significant negative impact on the company. The author cites research showing “that restatements result in significant negative stock price reactions…and increase the probability of litigation….The literature also discusses the negative effects of a restatement on the firm’s ability to raise capital. For example, [a 2004 study found] that a firm’s cost of capital increases between 7% and 19%, following a restatement.”
But why the lower restatement rate? The author interpreted the results under the “inter-organizational embeddedness theory,” a theory suggesting that “outside directorships of executives provide opportunities to learn and network and, in turn, bring value to the home firm by helping avoid costly financial restatements….Overall, the results suggest that outside directorships connect CFOs to other executives and directors, who can be sources of counsel and insight.” In that regard, the author cites a 2012 EY report suggesting that the benefits to CFOs may include

“‘a better understanding of boardroom dynamics, the cross-pollination of ideas and best practices, and exposure to a different corporate culture’…. The board of directors is potentially served by executives with a diversity of knowledge and experiences and alternative points of view. While serving on outside boards, CFOs interact with other directors, thus enriching their own knowledge and experience, beyond what they can learn at the home firm. [A 2008 study suggested] that fellow directors on board can be sources of advice and counseling both during normal and critical times, which may help improve firm performance….Overall, the inter-organizational embeddedness perspective suggests that CFOs can gain problem-solving expertise from being on an outside board and that these skills can be used to better discharge their fiduciary responsibilities and resolve issues at the source firm.”