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Board influence on the selection of external accounting executives

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ABSTRACT

We hypothesize that boards of directors systematically influence the selection of external candidates to the top accounting executive position. This inquiry is motivated by prior evidence that boards influence the selection of external candidates to the CEO position, and by evidence that boards influence financial reporting outcomes. Analyzing a comprehensive sample of top accounting executive appointments from the United States we identify links between board attributes and the likelihood of an external accounting executive appointment. We also find that external appointments are more likely to be associated with forced compared to voluntary turnover. The importance of accounting executive turnover is reinforced by analysis of changes in discretionary current accruals. Together, the results are broadly consistent with boards being involved in the appointment of accounting executives, and monitoring in this way the firm's accounting function.
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Data availability: The list of firm-appointments, the data coded from each announcement, and the detailed board data from the proxy statements are available from the authors upon request.

1. Introduction

The recent financial reporting scandals and ensuing regulation have focused considerable attention on the executives in charge of the corporate accounting function. In particular, a rapidly growing number of academic studies have shed light on the link between financial reporting quality and financial executive turnover (e.g., Arthaud-Day, Certo, Dalton, & Dalton, 2006; Desai, Hogan, & Wilkins, 2006; Geiger & North, 2006), leading to a growing realization that the level of accounting quality is both an antecedent and a consequence of financial executive turnover. Importantly, analyzing financial executive departure alone does not provide a complete picture of turnover unless one considers the person replacing the departing executive. Geiger and North (2006) suggest that the origin of the successor is an important appointment parameter, and document evidence that externally appointed CFOs are associated with greater changes in discretionary accruals compared to internally promoted candidates.

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Casual observation suggests nearly half of all newly appointed financial executives are promoted from within the firm while the rest are selected from outside. Despite the apparent importance of the origin of financial executive hires, the conditions under which a firm opts for an external over an internal hire are not currently well understood. Further, although prior academic research has linked boards of directors to CEO successor affiliations (e.g., Huson, Parrino, & Starks, 2001), it is not a priori clear whether the findings of research linking boards to CEOs can be extended to lower level financial executives. The present study combines these two strands of research by examining the factors leading a firm to choose an external over an internal candidate to head its accounting function, and in particular the role of the firm's board of directors in making this decision. It is important to note this study focuses on top accounting executives, the officers of the corporation who are responsible for all accounting tasks, and have no non-accounting (e.g., finance) responsibilities. As explained in the next section of the paper, we believe this choice provides a cleaner setting for testing the role of boards in the turnover of the firm's accounting decision makers.

We posit three main expectations. First, we expect that accounting executive origin is dependent on the profile of the board of directors that is responsible for making the hiring decision. To the extent that hiring an external top accounting executive is more consistent with shareholder interests, then more diligent boards are expected to be more likely to hire an outside candidate to fill this position (see analogous empirical evidence for board influence on external CEO hires by Boeker & Goodstein, 1993; Borokhovich, Parrino, & Trapani, 1996; Dahya & McConnell, 2005; Huson et al. 2001; and theoretical evidence by Hermalin, 2005). Second, we expect that the need to hire an outside candidate will be more pronounced when the firm has exhibited poor accounting quality in the past, essentially forcing the departing executive out of the firm. The rationale is that a firm facing accounting problems is in a greater need for a change in its accounting policies. Finally, given that boards tend to become more active at times of crises, we expect that an effective board is associated with a higher likelihood accounting problems will lead to an external appointment.

To address the research questions in hand we compile and use an elaborate dataset combining data on appointee origin and turnover reasons that are coded from the appointment announcements; the appointing firm's board and ownership profile that is coded from corporate proxy statements; and data on accounting problems firms encountered that are identified through SEC filings, articles in the financial press, and GAO reports. The statistical tests employ a total of 941 firm-appointments, comparing the characteristics of 544 external and 397 internal firm-appointments.

Our analysis is separately performed for the pre- and post-Sox periods. This treatment is motivated by a long line of papers that are centered around the impact of Sox on corporate governance (e.g., Burks, 2011; Collins, Masli, Reitenga, & Sanchez, 2009). The tension in this debate stems, on one hand, from the position that increased disclosure and tighter regulation following Sox trigger more effective monitoring through various facets of governance. On the other, there is a belief Sox regulation imposed additional unnecessary costs on firms, leading to seemingly homogeneous board structures without affecting the substance of governance quality. Therefore, a secondary quest of our paper is to extend earlier work, providing some empirical evidence of how accounting executive turnover, and the role of boards of directors upon it, changed after Sox regulation.

The results are consistent with the board of directors being involved in the determination of accounting executive origin. Other things equal, external appointments are more likely when the appointing firm has a more effective board. We also find evidence that in the post-SOX period external appointments are more likely in cases where accounting problems lead to forced turnover. Finally, in the post-SOX period accounting-related forced turnover leads to external appointment when boards are small.

Our results contribute to prior literature in the following ways: First, the results extend the rapidly growing financial executive turnover literature by illuminating empirical determinants of the appointed financial executive's origin, and providing evidence, albeit indirect, regarding the role of the hiring board in this decision. Our results from accounting executives appears to be aligned with existing evidence on the importance of external CEO and CFO appointments (e.g., Arthaud-Day et al. 2006; Desai et al. 2006; Geiger & North, 2006). Compared to external appointments in the CEO and, to a lesser extent, the CFO post, instituting change in a more strictly defined area like accounting is a more concrete task, suggesting there are specific steps external accounting hires can take to achieve change. Also, given the more specialized technical knowledge of the accounting job, compared to the higher level CEO and CFO posts which require a broader set of skills, the availability of more technically qualified accounting candidates externally is an important issue for the hiring bodies to consider.

Second, the results extend prior accounting research that has linked board attributes to accounting quality (e.g. Agrawal & Chadha, 2005; Dechow, Sloan, & Sweeney, 1996; Klein, 2002; Setia-Atmaja et al. 2011) by empirically showing one specific means boards may employ to control accounting quality in public corporations; involvement in accounting executive hiring decisions. Third, our results extend prior evidence that has suggested boards are systematically involved in the likelihood of CEO turnover (e.g., Huson et al. 2001; Weisbach, 1988) and the selection of a CEO replacement (e.g., Boeker & Goodstein, 1993; Borokhovich et al. 1996; Huson et al. 2001). Given that, in theory, boards delegate decision rights to CEOs to manage the firm's human capital, the extent of board involvement in the hiring of executives other than the CEO is not a priori clear. This study finds results that are consistent with boards being involved in the selection of lower level corporate executives. Finally, this study reports some evidence of discretionary accruals changes following accounting executive turnover, extending a large body of accounting research on discretionary accruals around other corporate settings, including studies focusing on CFOs and CEOs (e.g., Bergstresser & Philippon, 2006; Geiger & North, 2006).

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