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Review on the Role of Financial Literacy in Accounting System

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Abstract: *Despite the need of financial literacy for audit committees to effectively perform their duties, there is a lack of extensive research and a clear definition of what exactly constitutes financial literacy for both audit committees and business students. Coates et al. conducted a study at the University of Chicago using a tool developed by Schipper and Weil. The study focused on examining the financial literacy of both firm board members and MBA students. Based on their research, both groups lack the required level of financial literacy. To advance this research, the same instrument is employed to evaluate the financial literacy of undergraduate accounting and finance students at a private university in the Midwest. Given the absence of a universally accepted definition of financial literacy in the accounting profession, it is advisable to exercise caution when interpreting this data.*

Keywords: Financial literacy, corporate governance, financial expert, audit committee, and literacy testing

I. INTRODUCTION

Financial literacy refers to the knowledge and understanding of financial concepts, such as budgeting, saving, investing, and managing personal finances.

Since the beginning of the 21st century, the performance of our nation's public enterprises has been greatly impacted by the level of financial knowledge possessed by individuals (or the lack thereof). Public corporations have been required to ensure the accuracy of their financial statements ever since the Securities and Exchange Commission (SEC) implemented the Exchange Act in 1934.

Since the early 1940s, the Commission has persistently advocated for robust and autonomous audit committees, in collaboration with the auditing and business sectors. As early as 1940, the Commission advocated for the adoption of audit committees consisting of independent directors. An audit committee composed of independent directors is more qualified than a management-linked committee to assess the quality of the issuer's financial disclosure and the adequacy of internal controls.

The Treadway Commission, also known as the National Commission on Fraudulent Financial Reporting in 1987, the General Accounting Office in 1989, and the Blue Ribbon Committee on Improving Audit Quality in 1999, have all expressed their endorsement for robust and autonomous audit committees. The Treadway Commission was sponsored by several prominent organizations, including the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute (now Financial Executives International), the Institute of Internal Auditors, and the National Association of Certified Public Accountants.

II. REVIEW OF LITERATURE

The existing literature suggests that directors were often identified as rubber stamp decision makers who lacked understanding of the nature of their tasks (Douglas, 1934). The source cited is Baker (1945). After the Commission conducted an examination into the auditing practices of McKesson & Robbins, Inc. in 1940, the auditing community modified its own auditing practices in response to the Commission's report. Subsequent to that, there were multiple deliberations over the suitable proportion of those with internal knowledge vs those without, as well as the optimal makeup of the board. The SEC Accounting Series Release (ASR) No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940), in the case of McKesson & Robbins, has been extensively studied in relation to performance composition. Notable studies by Koontz (1967), Baysinger (1985), Barnhart (1998), and numerous others have focused on this

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aspect. In 1972, the Commission recommended that businesses establish audit committees consisting of external directors (see to ASR No. 123). The date is March 23, 1972. The Commission implemented regulations mandating the disclosure of information regarding audit committees in 1974 and 1978 (see to Release Nos. 34-11147 (Dec. 20, 1974) and 34-15384). The date is December 6, 1978. However, the financial literacy of the participants has been disregarded in favor of broader issues such as composition and balance.

The increased awareness of the topic is evidenced by a working paper from Edinburgh (Song and Windram, 2000) which concludes that audit committee financial literacy reduces the probability of standards violations. Song and Windram (2000, p. 23) state that this discovery supports the suggestion made by the Blue Ribbon Committee to establish a training program for audit committee members and non-executive directors.

A recent study (Coates et al. 2007) developed a classification to evaluate the financial literacy of audit committees. To test the financial literacy of corporate board members and MBA students, a tool established by Schipper and Weil (Morse, 2004) was utilized. Schipper and Weil (Morse, 2004) have investigated and provided assistance for the education of directors through the programs they established at the University of Chicago. According to Coates et al. (2007), it is necessary for audit committees to enhance their financial literacy. The study found that organizations with evidence of improved audit committee performance had higher annualized abnormal returns compared to those that did not. This study includes references supplementary studies that examine issues related to audit committee such as expertise, autonomy, and professional qualifications, without directly evaluating financial literacy.

Over the past decade, the importance of financial literacy among audit committee members has been acknowledged by Congress, the SEC, the NYSE, the NASD, and the accounting profession. According to a suggestion made in 1999 by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which was organized by the NYSE and the NASD, it is advised that all publicly traded companies should form an audit committee consisting of at least three members who possess financial literacy. The committee does not offer a specific definition of financial literacy, but it does indicate that it refers to the capacity to comprehend and interpret essential financial documents such as a company's balance sheet, income statement, and cash flow statement (Blue Ribbon Committee, 1999, p. 26).

In December 1999, the NYSE implemented a regulation mandating that companies must form an audit committee consisting of independent directors who possess financial literacy, with the inclusion of at least one financial specialist. The guideline does not provide a specific definition of financial literacy, but it states that the company's board of directors will interpret it according to their own judgment. If the member does not already possess financial literacy, they must acquire it within a reasonable timeframe after joining the audit committee.

Under the provisions of the Sarbanes-Oxley Act (SOX) of 2002, public companies are required to either provide a valid explanation for not having a "financial expert" on their Audit Committee, or alternatively, appoint one. Financial competence, as contrast to financial literacy, necessitates certain experiential qualifications as outlined by SOX.

This study builds upon recent research that assessed the financial literacy of board members and MBA students. The objective of this study is to assess the current level of financial literacy among undergraduate and graduate business students, as many of them are likely to be involved in serving on audit committees of publicly traded businesses. First, we establish a clear understanding of financial literacy. Then, we examine a study conducted by Coates et al. in 2007, which evaluated the financial literacy of board members and MBA students at the University of Chicago. In the subsequent sections, we will outline our study, provide the results, and make a comparison with studies that have investigated the financial literacy of corporate executives and board members. Lastly, we analyze the findings of these studies regarding the financial literacy of existing and prospective members of the board and audit committee.

The definition provided by the Blue Ribbon Committee lacked clarity in terms of technical comprehension. Coates et al. (2007) established criteria for financial (accounting) literacy by examining the mandatory disclosure of Critical Accounting Policies and Estimates in an annual report. Their evaluation criteria focused on understanding the following concepts: the business model, the application of GAAP and IFRS for recognition and measurement, the alignment of management's judgements and estimates with the business model, and the impact of management decisions on the potential manipulation of financial reporting. These standards align with the interpretation of financial data suggested by Hills and Weil (2004), which is essential for the audit committee to effectively fulfill its responsibilities. We adopt Weil's definition of financial literacy, which encompasses the concept of accounting literacy (Morse, 2004, p. 22).

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In a 2004 interview published in the Harvard Business Review, Dr. Roman Weil noted that the presence of audit committees, which one might assume to be a fundamental requirement, is really relatively rare. How can the audit committee fulfill its oversight function if it does not understand these judgments and the amount to which management has used its discretion to change reported income? (Morse, 22.)

Schipper and Weil (Morse, 2004) have been administering a multiple-choice examination on financial (accounting) literacy to members of corporate boards for a considerable period of time. The queries pertain to matters of accounting and the audit committee. According to Coates et al. (2007), a total of 1,400 individuals took part in executive education seminars for board members and corporate officers at the University of Chicago Graduate School of Business, Stanford Law School, and Wharton between 2002 and 2005. The majority of the audience consisted of board members, CEOs, CFOs, and general counsel. 20% of the audience consists of attendees who serve on audit committees. The individuals who have successfully completed the quiz are designated as "Directors" for the purpose of this study. Out of the 25 questions on the test (Exhibit 1), 13 of them can be answered by referring to a textbook on basic accounting specifically designed for first-year MBA students. Out of the remaining 12 questions, four are related to the audit committee, while the other eight require a comprehensive comprehension of many intricate topics that are currently significant to numerous firms. Advanced subjects in finance include special purpose entities, reserve use, restrictions, issuance of shares in return for IOUs, stock options, derivatives, and income manipulation.

III. CONCLUSION

Financial literacy encompasses the comprehension of the pivotal accounting decisions made by management, the rationale behind those decisions, and the potential utilization of those decisions to manipulate financial statements.

Management may suffer market demands for immediate performance and the associated pressures to match market expectations. The utilization of compensation or other rewards focused on immediate stock value growth, which could encourage self-interest rather than the advancement of long-term shareholder interest, may exacerbate these pressures. Self Regulated Organizations (SROs) first introduced audit committee requirements in the 1970s, mostly due to the endorsement of the SEC. The resolution of this matter can be achieved by establishing an independent audit committee equipped with adequate resources, so ensuring the alignment of the corporation's interests with those of its shareholders.

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