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Study on Importance of Financial (Accounting) Literacy

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Abstract: *There is limited empirical research and no definitive definition of what constitutes financial literacy for audit committees and business students, despite the fact that it is crucial for an audit committee to carry out its tasks. Using a tool created by Schipper and Weil, Coates et al. conducted a study at the University of Chicago that looked at the financial literacy of company board members and MBA students. According to their findings, neither group possesses the necessary level of financial literacy. In order to further that research, this work uses the same tool to assess the financial literacy of undergraduate accounting and finance students at a private university in the Midwest. Since the accounting profession does not have a standard definition of financial literacy, caution should be applied when interpreting these data.*

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

I. MEASURING FINANCIAL LITERACY (ACCOUNTING LITERECY)

Since the turn of the century, the success or failure of our country's public corporations has been significantly influenced by financial literacy (or a lack thereof). The obligation to maintain the truth of their financial statements has been placed on public firms since the SEC's adoption of the Exchange Act in 1934.

The Commission has consistently supported strong, independent audit committees, along with the auditing and corporate communities, since the early 1940s. The Commission promoted the usage of audit committees made up of independent directors as early as 1940. A committee that is linked with management is less qualified to evaluate the quality of the issuer's financial disclosure and the sufficiency of internal controls than an audit committee made up of independent directors.

Market pressures for immediate performance and related pressures to meet market expectations may be experienced by management. The use of remuneration or other incentives centred on short-term stock appreciation, which might promote self-interest rather than the promotion of long-term shareholder interest, may increase these pressures. This issue can be resolved and the interests of the corporation and shareholders can be aligned with the help of an independent audit committee with sufficient resources. Self Regulated Organizations (SROs) originally implemented audit committee standards in the 1970s, largely as a result of the SEC's support.

The National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission (National Commission on Fraudulent Financial Reporting, 1987), the General Accounting Office, which released "CPA Audit Quality: Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies" (GAO, 1989), and the Blue Ribbon Committee on Improving Audit Quality have since expressed support for strong, independent audit committees (1999). 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 sponsored the Treadway Commission.

Early research indicates that directors were frequently found to be rubber stamp decision makers who did not comprehend the nature of many of their responsibilities (Douglas, 1934). (Baker, 1945). Following the Commission's 1940 investigation into McKesson & Robbins, Inc.'s auditing practises, the auditing community changed its auditing practises as a result of the Commission's report. Numerous discussions about the appropriate ratio of insiders to outsiders and the right board composition followed In the Matter of McKesson & Robbins, the SEC Accounting Series Release (ASR) No. 19, Exchange Act Release No. 2707 (Dec. 5, 1940), with the majority of studies focusing on performance as it related to composition (Koontz, 1967, Baysinger, 1985, Barnhart, 1998, and countless others). For

instance, the Commission advised businesses to form audit committees made up of outside directors in 1972 (See ASR No. 123). (Mar. 23, 1972). The Commission established regulations requiring disclosures concerning audit committees in 1974 and 1978 (see Release Nos. 34-11147 (Dec. 20, 1974) and 34-15384). (Dec. 6, 1978). But the participants' financial literacy has been overlooked in favour of more overarching considerations like composition and balance.

A working paper from Edinburgh (Song and Windram, 2000) that draws the conclusion that audit committee financial literacy lowers the likelihood of standards violations shows the growing awareness of this topic. "This finding seems to substantiate the Blue Ribbon Committee's recommendation to implement a training programme for audit committee members and, in fact, for non-executive directors," write Song and Windram (2000, p. 23).

A categorization was created recently (Coates et al. 2007) to assess the financial literacy capacity of audit committees, and an instrument created by Schipper and Weil (Morse, 2004) was used to assess the financial literacy of corporate board members and MBA students. Through the programmes they created at the University of Chicago, Schipper and Weil (Morse, 2004) have looked into and supported the education of directors. Coates et al. (2007) draw the conclusion that audit committees must increase their financial literacy and that, for those businesses where there is evidence of the audit committee's improvement, the organisations experienced annualised abnormal returns as opposed to those that did not. This study also cites additional studies that look at audit committee problems like knowledge, independence, and professional backgrounds while not explicitly assessing financial literacy.

The necessity of financial literacy among audit committee members has received attention from Congress, the SEC, the NYSE, the NASD, and the accounting profession over the last ten years. All publicly traded businesses should establish an audit committee with at least three "financially literate" members, according to a 1999 recommendation made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, which was organised by the NYSE and the NASD. A general definition of financial literacy is not provided by the committee, but it does state that "Such 'literacy' signifies the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement" (Blue Ribbon Committee, 1999, p. 26).

The NYSE established a rule in December 1999 requiring corporations to have an audit committee made up of independent, financially literate directors and including at least one financial expert. The guideline does not define financial literacy, but it stipulates that the company's board of directors will interpret it as it sees fit. Should the member not already be financially literate, he or she must do so within a reasonable amount of time after joining the audit committee.

According to the Sarbanes-Oxley Act (SOX) of 2002, public businesses must either justify their lack of a "financial expert" on the Audit Committee or have one. Financial expertise, as opposed to financial literacy, has specific experience requirements as defined by SOX.

This study expands on recent studies that evaluated board members' and MBA students' financial knowledge. One goal of this study is to evaluate the present financial literacy of undergraduate and graduate business students because many of them can anticipate serving on audit committees of publicly traded companies. We start with a definition of financial literacy before looking at study done by Coates et al. in 2007 that assessed board members and MBA students at the University of Chicago for their financial literacy. In the following sections, we will describe our study, show the findings, and compare them to studies that examined the financial literacy of corporate officials and board members. Finally, we examine what these studies have to say about the financial knowledge of current and potential members of the board and audit committee.

II. DEFINITION OF FINANCIAL LITERACY

Regarding technical understanding, the Blue Ribbon Committee's definition was not very explicit. Based on the required disclosure of Critical Accounting Policies and Estimates in an annual report, Coates et al. (2007) created criteria for financial (accounting) literacy. Their evaluation criteria were centred on knowing the following concepts: the business model, the recognition and measurement of GAAP and IFRS, whether management's judgements and estimates are consistent with the business model, and the implications of management decisions for potential financial reporting manipulation. Such requirements are in line with the understanding of financial data proposed by Hills and Weil (2004), which is necessary for the audit committee to adequately carry out its duties. We utilise Weil's definition of financial literacy, which incorporates the idea of accounting literacy (Morse, 2004, p. 22):

Dr. Roman Weil made the following observation in an interview published in the Harvard Business Review in 2004: "You'd think that would be a basic necessity for audit committees, but it's quite scarce... If the audit committee doesn't comprehend these kinds of decisions and the extent to which management has exercised its discretion to alter reported income, how can it fulfil its oversight duty? (Morse, 22.)

For many years, Schipper and Weil (Morse, 2004) have created and given a multiple-choice exam on financial (accounting) literacy to company board members. The questions address issues with accounting and the audit committee. Over 1,400 people participated in executive education seminars for board members and corporate officers held at the University of Chicago Graduate School of Business, Stanford Law School, and Wharton over the period 2002–2005, according to Coates et al. (2007). Board members, CEOs, CFOs, and general counsel made up almost the whole audience. Attendees who are on audit committees make up 20% of the audience. The guests who successfully finished the quiz are referred to as "Directors" for the purposes of this study. 13 of the 25 questions on the test (Exhibit 1) had answers that can be found in a textbook on fundamental accounting for first-year MBA students. Four of the remaining 12 questions pertain to the audit committee, and eight more call for a thorough understanding of several complex subjects that are currently important to many businesses. Special purpose entities, the use of reserves (two questions), restricting, issuing shares in exchange for IOUs, stock options, derivatives, and income manipulation are among the advanced topics.

Understanding the crucial accounting decisions that management takes, why management makes those decisions, and how management might utilise those decisions to manipulate financial statements are all aspects of financial literacy.

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