

# **Audit Committee regulation**

## **‘Financial literacy’ - what does it mean?**

**Paper prepared for the Audit Committee Chair Forum**  
by Dr Ruth Bender, Cranfield School of Management

The Audit Committee Chair Forum (ACCF) is convened by the CBI and Ernst & Young working in association with Cranfield University, which facilitates the meetings and produces the outputs.

The Forum comprises a group of audit committee chairs from the UK's leading companies. It exists for senior audit committee chairs to:

- network, debate best practice and share concerns, and/or
- identify lobbying points for the CBI.

The forum provides an opportunity to contribute to the debate, influence its direction and improve the performance of audit committees.

The forum is chaired by Sir Anthony Greener, Deputy Chairman of BT Group with Gerald Russell, Senior Partner at Ernst & Young, and John Sunderland, President of the CBI, as vice chairs.

This is the second paper produced by the ACCF. The first, 'The role and function of the Audit Committee', raised some interesting points about the effectiveness of audit committees and is available electronically. To obtain copies or discover more about the ACCF please contact the forum secretary, Kay McCulloch at the CBI, at [kay.mcculloch@cbi.org.uk](mailto:kay.mcculloch@cbi.org.uk).



## Executive summary

### **Audit Committee Regulation 'Financial literacy' – what does it mean?**

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- Corporate governance regulations in the UK, the EU and the US all state that there should be a certain level of financial literacy within the membership of the audit committee. However, the rules differ in important detail between jurisdictions.
- The audit committee chairs participating in this research agreed that there is a need for one or more committee members to be financially literate, but there was no consensus as to what would comprise 'financial literacy' or whether it was necessary for the committee's financial expert to be a qualified accountant.
- There was a view expressed by many that it is more important for members of the audit committee to be 'business literate' than financially literate. Some extended this to the audit committee chair; others stated that it applied to members only.
- There were mixed views as to how much audit committee chairs and members need to know about international standards on auditing. However, it was apparent that there is an expectations gap in that some participants were not aware of how little detailed 'ticking and bashing' auditors do in today's risk-based environment.
- All participants agreed that there is a need for ongoing training of audit committee members. In many companies this is done on an individual basis rather than formally arranged by the committee. The most common source of updates is seminars put on by the company's auditors and other Big Four accountants. There was consensus that such training should be specific to the needs and context of the company, and a generic syllabus would not be appropriate. Audit committee chairs and the 'financial experts' need more training than other members of the committee.



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# Introduction

Audit committees of United Kingdom listed companies are regulated by the Combined Code (2003), as interpreted through the Smith Guidance (2003). In the United States, the Sarbanes-Oxley Act (Sarbox, 2002) sets out the requirements for audit committees, and it is extended by the listing requirements of the stock exchanges. Within the European Union, countries have their own regulations, but the 8th Directive (2005) seeks to attain high-level (but not full) harmonisation of practice.

An examination of the various regulations shows that they agree in substance. In all regimes the audit committee should comprise (solely or mainly) non-executive directors (NEDs), preferably independent. In all regimes the role of the audit committee encompasses reviewing the company's published financial information, and reviewing accounting systems and internal controls. And in all regimes there is a requirement for some level of financial knowledge on the audit committee.

If the move towards harmonisation of practices internationally impacts on UK audit committees, it will be useful to understand the differences between the jurisdictions in advance of such regulation coming in, in order to prepare for or, if necessary, challenge it. Of particular interest in this paper are the requirements regarding financial literacy of audit committee members.

This paper reflects the discussions of a meeting of the Audit Committee Chair Forum (ACCF) held on 5th April 2006 regarding the need for financial literacy in audit committee chairs and members. Additionally it draws upon telephone interviews with four members of the ACCF who did not attend the meeting, and on interviews and discussions previously conducted with members of the ACCF.

The interviews and meeting directly related to this matter solicited the views of nine Chairs of the audit committees of FTSE 350 companies, and three audit partners from Ernst & Young. Of the audit committee chairs included in this research, it is relevant that four are qualified accountants who have held the position of chief financial officer (CFO) or finance director (FD).

On many issues, there was no consensus between the participants. In particular, there were differences between the views of those who attended the ACCF meeting, where a wide-ranging discussion was held, and those interviewed individually by telephone. This paper presents the range of views expressed, and indicates how common they were to the group as a whole.

## What is ‘financial literacy’?

*“I’m not an accountant but consider myself a reasonably competent chairman of two audit committees. ... But if I hadn’t spent most of my career dealing with accounts I wouldn’t be comfortable.”*

Governance regulations surrounding audit committees differ in significant respects between the UK, the EU and the US. Although superficially they resemble each other – each demands a certain level of ‘financial literacy’<sup>1</sup> in the audit committee – they do in fact diverge in important aspects. Appendix 1 summarises the various laws and regulations applying in the different jurisdictions. In each jurisdiction the broad duties of the audit committee are the same. However, as they differ in their detail, Appendix 2 sets out a table of the main duties of the audit committee under each set of regulations.

Given that there is a need in most jurisdictions for at least one member of the audit committee to be financially literate, it might be supposed that there is a clear, agreed definition of what such financial literacy comprises. There is not, either between the regulations, or in the understanding of the sample of UK audit committee chairs and audit partners participating in this research.

The definition used in the UK’s Combined Code refers to “recent and relevant” experience. As discussed below, no clarification is given as to how recent the experience should be, nor indeed how relevant. As far as we are aware, the definition of “recent and relevant” has not been tested in the courts.

Sarbox does not refer to ‘recent’ experience, but sets out a clear vision of what would comprise ‘relevant’, including all of; an understanding of GAAP<sup>2</sup> and its application; experience of accounts preparation, audit, analysis or evaluation; understanding of internal controls and procedures; and an understanding of audit committee functions. This is a considerable requirement, the most demanding of all the jurisdictions discussed.

Academic research in the US indicates that companies whose audit committees include financially literate individuals are less likely to suffer financial reporting problems, and their committees are better able to understand the companies’ internal controls<sup>3</sup>. However, it is difficult to state whether ‘literate’ audit committees do better than ‘non-literate’ because of the knowledge that members bring, or because financially literate individuals are generally attracted to the better companies.

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<sup>1</sup> In this paper, the term ‘financial literacy’ is used as a proxy for the various terms used in the different regulations.

<sup>2</sup> Generally Accepted Accounting Principles

<sup>3</sup> DeZoort et al. (2002) synthesized the academic literature on audit committees, commenting upon the composition, authority, resources and diligence of audit committees and their members. They found that members’ expertise was positively associated with backing for the auditor in disputes, and (paraphrasing) a more thorough and informed approach to the work, with fewer financial reporting problems.



## ‘Recent and relevant’

The UK’s Combined Code does not have a detailed definition of the financial literacy requirements of audit committees. Section C.3.1 states that at least one member of the audit committee should have “recent and relevant financial experience”. As mentioned previously, neither ‘recent’ nor ‘relevant’ is defined, and one of the issues discussed with the research participants was their different practical applications of these terms.

### How recent?

It is difficult to come to an acceptable definition of ‘recent’. One chair, with a very recent background as a CFO, took the view that the rate of change in financial reporting meant that anyone who had not been involved in the preparation of financial statements for the current year would be out of date.

*“How can anyone have that [recent and relevant experience] with regards to IFRS? ... Anyone who’s been retired more than 2-3 years will have no idea – unless they’re seriously nerdy – about international accounting standards.”*

This view was supported independently in a telephone interview with another chair who was in a similar situation. However, that individual went on to point out that it is impractical for all audit committee chairs to have very recent experience, and compromises have to be made. Otherwise a situation could develop whereby all audit committee chairs would have to have been FDs or audit partners within, say, the past five years. This would greatly limit the pool of available individuals. As one of the ex-CFO chairs stated, “You can’t define the hell out of it so that there are only nine of us left in Britain!”.

A related issue is the level of comfort that the individuals feel about their own financial knowledge. As one of the participants commented:

*“I feel that I’m as up to date as I need to be. Even though I’m ten years from banking. Had I not had audit committee experience during those ten years, I would feel very exposed.”*

The implication of this assertion, with which other discussion participants agreed, is that experience on an audit committee, and the related training implicit in such membership, are themselves considered sufficient to meet the needs of the regulations.



## How relevant?

*“Accounts speak to me. Notes to the accounts speak to me.” [Chair with no accounting background]*

*“I think you absolutely need one [an accountant] to chair it. ... My view would be that if I were chairman of a company, I wouldn't dream of having my chair of audit as not being someone with a pretty good financial background.” [Chair who was an ex-CFO]*

The above quotations illustrate the wide range of participants' views.

Although Sarbox specified the type of experience that it considers to be relevant, the UK's Combined Code has no such guidance. It is up to boards and their members to determine whether the experience is relevant, and this research showed that there is no consensus.

An academic working paper by Coates, et al. reviews audit committee financial literacy in the US, and reports on the results of tests done on audit committee members' knowledge of accounting. In reviewing financial literacy the authors refer to the 1999 Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, where financial literacy is defined as:

*Such 'literacy' signifies the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement.*

The authors make several interesting arguments, based on their research. They point out that 'financial literacy' is not the same thing as 'accounting literacy' and suggest that it is actually the latter that is needed by audit committee members. Many CFOs have arrived in their roles through the routes of treasurer, general counsel or corporate finance, and such individuals often have an impressive grasp of finance without ever having had to get involved in detailed accounting issues. The work done by that research team indicated that individuals who would appear to be 'financially literate' were not 'accounting literate'. Appendix 3 sets out the criteria used by those researchers in their test of accounting literacy.

It is worth noting that the SEC's original interpretation of the Sarbox legislation was that accounting literacy was required. This was amended in their Final Rules, following much comment and concern that the proposals were too restrictive. The wording shown in Appendix 1, whilst still quite prescriptive, reflects a broader range of financial knowledge than originally suggested.

The views of the ACCF members diverged sharply as to whether audit committee chairs needed to be ‘accounting literate’. Those attending the meeting (including one ex-CFO) took the view that business literacy was considerably more important than knowledge of accounting. Of the telephone interviewees, one (who had no formal financial or accounting background) opined that business understanding was far more relevant than accounting knowledge, and two (both of whom had been CFOs) were strongly of the opinion that accounting knowledge was necessary. The other, with a banking background, was of the view that it was helpful for one member of the committee to have an accounting background, but that need not necessarily be the chair.

*“There is more to being a chairman of an audit committee than just understanding accounting.” [Chair who was an ex-CFO]*

### Who needs to be financially literate?

*“It would be a shame if everyone [on the audit committee] had to be financially literate.”*

The UK and EU regulations refer to at least one member of the committee having financial experience. The UK’s Smith Guidance states (s.2.17) that the need for a degree of financial literacy among the audit committee members other than the chair will vary according to the nature of the company. Sarbox requires the company to disclose who is its “audit committee financial expert”, with the qualifications described above.

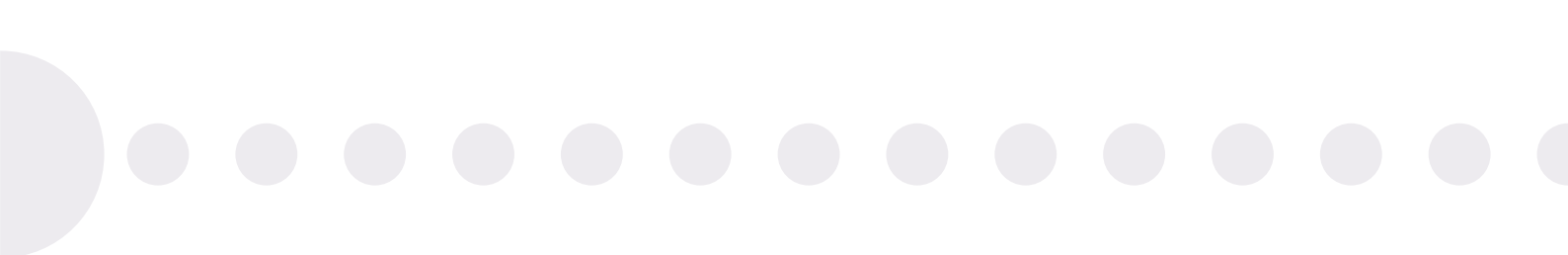
A key issue is whether or not the financial literacy requirement should be met by an individual, or can be met collectively. Both the EU 8th Directive<sup>4</sup> and the Combined Code refer specifically to “at least one member” having this experience, although some UK companies are currently interpreting this to include the collective experience of the committee.

The Financial Reporting Council (FRC), in its review of the Combined Code, noted (para 22-23) that some companies were having difficulty in complying with the requirement for an individual to have the experience and were instead stating that the committee as a whole was so qualified. The FRC noted that this does not comply either with the Code or with the 8th Directive. The FRC has drawn this issue to the attention of the Department of Trade and Industry (DTI), which will be responsible for implementing the 8th Directive into UK law.

The NYSE listing requirements take the need for financial literacy one stage further, requiring, in addition to the acknowledged ‘financial expert’, that each member of the audit committee should be financially literate (or should become so within a reasonable period after joining the audit committee).

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<sup>4</sup> The 8th Directive also refers to a Commission Recommendation of 15th February 2005, which expands upon the role of non-executives.



The participants in this research had mixed views as to whether it was appropriate for one, some or all members of the audit committee to be financially literate (or indeed accounting literate). There was a general agreement that it is useful to have at least one individual with such experience on the committee, as this can improve the quality of the discussion.

As regards the view that all members of the committee should have financial knowledge, again views differed. Only one interviewee took the position that it would be an advantage for all to have financial (not necessarily accounting) knowledge. However, most argued that audit committees cover a range of responsibilities, and an insistence on all members being financially literate might mean that some other useful skills could not be brought to the committee. All took the view that every member should be business literate, which implies a certain level of comfort with financial information.

Many participants were of the view that individuals who sit on the boards of large companies would automatically be business literate and understand financial statements, as it would be difficult to achieve such positions without this knowledge. However, on prompting they did agree that functional experts on boards, both executive and non-executive, could be lacking in this area.

Two arguments were made against insisting that all audit committee members need to be financially literate. It was pointed out that a need for three financially literate NEDs to serve on the audit committee might mean that the board needed to be much bigger, to include individuals with other necessary skills. Secondly, it was noted that in some companies all of the NEDS choose to sit on the audit committee; a mandatory financial qualification would prevent this.

## Financial literacy in context

*“It’s for boards to judge whether they have enough people with [financial literacy]”*

Participants in the ACCF meeting were all of the view that it was important to appreciate the context of the company when determining what ‘financial literacy’ might mean. Members who were very comfortable chairing their own audit committees explained that they would not take such a job in, for example, a life assurance company, as their financial knowledge would not be sufficient for the job.

Accordingly, it would be difficult, and possibly inadvisable, to attempt to come up with a rigorous definition of financial literacy. The participants at the discussion agreed that companies need a degree of flexibility to make sure that the skills around the table properly reflect the circumstances of the company.

## Obligations on the ‘financially literate’ member of the audit committee

*“If I were in the US I wouldn’t touch the job.”*

It seems likely that a member of the committee who is acknowledged to be the financial expert will have a higher profile in any action taken by stakeholders if the company’s reporting is misleading, or its systems inadequate.

The Company Law Reform Bill, currently at the Committee Stage in Parliament, acknowledges this, stating (s.158) that a director must exercise reasonable care, skill and diligence as would be exercised by a person with the skill and experience that the director has. Thus a financially literate member of the audit committee may indeed have greater obligations than others as regards the company’s financial reporting.

It has been suggested, particularly in the litigious environment of the US, where the financial expert is clearly identified, that this could dissuade qualified individuals from taking positions on audit committees<sup>5</sup>.

A comment was made by two interviewees that one reason for UK companies to have no identified financial expert might be that the relevant individual was unwilling to put him/herself forward, rather than that the expertise did not exist. This links closely to the idea that the identified individual might be “the first guy to go to prison”. Related to that was the argument that it could be difficult for an individual to defend their ‘expertise’, given that the term “recent and relevant” is undefined. However, the chair that made this particular remark was of the opinion that closely defining the terms would disadvantage corporate governance in the UK, reducing the pool of available individuals to serve on audit committees.

## The triumvirate: audit committee, the auditors and the finance director

*“An audit committee ... wishes to present to the market a set of results which is a reasonable representation of the company, and a set of auditors ... would put up a red flag if that were not the case.”*

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<sup>5</sup> However, the SEC Final Rule on S.407 of Sarbox allows a ‘safe harbor’ provision to protect, to some extent, the designated audit committee financial expert. As discussed, no equivalent protection exists in UK law.

## Reliance on auditors and the finance function

The debate about financial and accounting literacy within the audit committee included a discussion of the role of the committee vis à vis the auditors and vis à vis the finance director.

One interviewee, whose background was not in accounting, stated that the audit committee should take its cue on accounting matters from the auditors rather than the company's finance function.

*“If you trust the executives you might as well shut up shop. If you are completely trusting ... what the hell's the point of the audit committee? You've got to be a sceptical friend.”*

Another, who had recent experience as a CFO, took a similar view:

*“They [audit committee members without an accounting background] are very reliant on the CFO, and surely the audit committee chair role is to challenge.”*

However, most of the research participants considered that close liaison with both parties was more appropriate. For example, one interviewee described the finance director, the auditors and the audit committee as a “triumvirate whose job it is to support each other in order to arrive at a true and fair view”.

*“It depends whether you regard the finance director and auditors as being on your side, or whether you regard them as antagonists.”*

The individual who made the above comment, an ex-CFO, was firmly of the view that all parties were on the same side, with the objective of producing financial statements that showed a true and fair view. His experience was that the sometimes vigorous discussions between the parties were a sign of professionalism, and had been useful to him in his previous role.

The implication of reliance on the auditor and/or the finance function is that audit committee members do not themselves need detailed accounting literacy, and business literacy with some basic financial knowledge is sufficient. The auditors should make clear their views on the accounting policies and treatments, and the audit committee can use its collective judgement – including that of the lay members – to make decisions.

*“Not quite the man on the Clapham Omnibus, because we need them to be business-literate. But ordinary businessmen trying to make sure that the proper processes have taken place.”*

## What do auditors do?

*“If you’re not turning up the carpet; who’s turning up the carpet?”*

*“What can we rely on you to do? What can we not rely on you to do?”*

Although the interviewees and participants in the ACCF discussion initially took the view that there was no great need for audit committee members to understand auditing standards, as the ACCF meeting progressed, it highlighted the usefulness of such knowledge. The conversation turned to the way audit work is structured, with little time being spent in traditional ‘ticking and bashing’ of transactions, and considerable focus being placed on risk assessment and systems analysis. Some of the participants were surprised, and perturbed, that the auditors were not carrying out the micro-analysis that they had presumed was taking place.

It was agreed that action needs to be taken to reduce this expectations gap. It would be useful for audit committees to discuss with their auditors exactly what is and is not covered during the audit. It would also be useful for them to have an understanding of the level of detail undertaken by internal audit in the organisation.

*“Auditing has subtly evolved without us understanding what is has evolved into.”*

Appendix 4 sets out extracts from UK regulations that indicate the work that audit committees should be doing. This has (undefined) implications for their auditing and accounting knowledge.

## The need for continued professional development

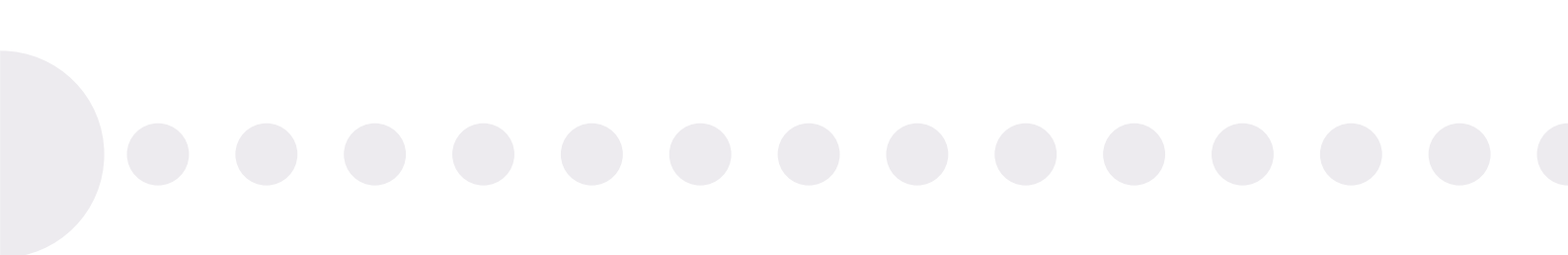
*“If members of the board recognise that their colleagues are not making that investment, they should kick them off. ... If people are not prepared to make the investment to do the job properly, they should not be allowed to do the job.”*

All of the people contributing to this report took the view that audit committee chairs and members need to stay up to date in order to perform their duties properly. All undertook some sort of training activities, mostly by attending seminars put on by their auditors, or by others of the Big Four accounting firms.

It was noted by two participants that an audit committee chair with an accounting qualification would be obliged by his/her professional body to undertake continued professional development (CPD).

It was thought difficult to formalise such CPD, as individuals have different backgrounds, and companies have different needs. Organisations in different industries and different stages of their lifecycle would face different audit and accounting issues, and so a generic audit committee training programme would not be useful: training should be specific to the needs of the committee at that time.

One chair suggested that it would be useful for company secretaries to arrange, for example, update sessions for the audit committee members on two afternoons a year, to be given by the auditors or by



another Big Four firm. These, together with individuals' membership of several different committees, would comprise a good basis for keeping up to date. One committee chair stated that it should be part of the committee's evaluation procedures that individuals self-assess their CPD and then the chair assesses whether the committee as a whole has done sufficient. However, another chair stated that he did not ask his members how they had updated their skills.

Appendix 5 sets out relevant extracts from the Combined Code concerning the need for NED development.

## Conclusions

All jurisdictions demand some level of financial literacy from their audit committees. Sarbox is quite prescriptive about what this should include; UK and EU regulation are less so. The Combined Code requirement for "recent and relevant experience" is interpreted in practice in many different ways.

There was no consensus between the participants in this research as regards to how financially or accounting literate audit committee chairs and members need to be. Opinions broadly reflected the individuals' background – most of the ex-CFOs were of the view that only someone with an accounting background could properly appreciate the work sufficiently to chair the committee, whereas those with no such professional background were of the opinion that their financial and business knowledge were sufficient.

Related to this, views differed on how much the audit committee should rely on the auditors. One contributor argued that if the audit committee was just relying on the auditor, what was the point of it? Another stated that the auditors, audit committee and finance director were a triumvirate, all working towards the same objective, which is to present accounts that show a true and fair view. In general, there was a view that the audit committee should be able to rely on the auditors for advice.

The research participants all agreed to the need for some sort of CPD for audit committee members, and more for chairs. However, the view was that CPD should be relevant to the individuals and to the particular needs of the business, and that a generic training scheme was unlikely to be appropriate.

An expectations gap was identified, in that some of the audit committee Chairs believed that auditors did more detailed transactions work than is actually the case. Committees need to be educated to understand more clearly what auditors do.



## Questions to ask yourself

- Does my audit committee have sufficient knowledge and experience to carry out its brief in this company? How do I know?
- Do I, as audit committee chair, have sufficient knowledge and experience?
- Should we set up a formal professional development programme to ensure that audit committee members are kept up to date on significant accounting, financial and governance issues that may affect the activities of the audit committee?
- How else should I/we be updating our accounting, financial and other knowledge to ensure that we comply with current regulation and, more importantly, to ensure that we can do a good job?
- Should we be meeting with the external and internal auditors to discuss in detail what work is being carried out on the company's detailed transactions?

## Appendix 1

### What is meant by 'financial literacy'?

	Requirement	Number of audit committee members to which it applies
<b>UK Combined Code</b>	Recent and relevant financial experience	At least one member of the audit committee
<b>EU 8th Directive</b>	Competence in accounting and/or auditing	At least one member of the audit committee
<b>Sarbanes-Oxley Act (as amended by SEC Final Rule dated 3rd March 2003)</b>	Someone who, through education and experience, has: an understanding of GAAP; the ability to assess its general application; experience in preparing, auditing, analyzing or evaluating financial statements of similar companies; understanding of internal controls and procedures; and an understanding of audit committee functions.	At least one member who is an "audit committee financial expert".  (There is, however, the opportunity for a company to state that it does not comply with this provision, giving as the reason the collective knowledge of the audit committee.)
<b>New York Stock Exchange company manual</b>	As interpreted by the company's board.	Each member must be financially literate and at least one member must have accounting or related financial management expertise.

## Appendix 2

# Main duties of the audit committee under the different regulations

	UK - Combined Code	EU - 8th Directive	US - Sarbanes-Oxley
1. External financial statements	To monitor integrity of the financial statements.	Monitor the financial reporting process.  Monitor the statutory audit of the annual and consolidated accounts.	The auditors are obliged to report directly to the audit committee about critical accounting policies used, alternative treatments discussed with management, and any material written communications they have had with management.
2. Internal controls and risk management	To review the company's internal financial controls (and its risk management systems unless monitored elsewhere).	Monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems. [Risk management can be done elsewhere in the board].	The CEO and CFO have to sign off on the company's internal controls. They have to disclose to the audit committee any frauds and significant deficiencies.  This is a matter for the management (under s.404) and auditors rather than specifically for the audit committee.
3. Internal audit	To monitor and review the effectiveness of internal audit		
4. Appointment of external (statutory) auditor	To recommend (to the board) appointment of the external auditor, and approve their remuneration and terms of engagement	Recommend to the board the appointment of the statutory auditor.	The audit committee is directly responsible for the appointment, compensation and oversight of the work of any audit firm, and the firm shall report directly to the audit committee.
5. Independence of external (statutory) auditor	To review and monitor the external auditor's independence, objectivity and the effectiveness of the audit process.	Review and monitor the independence of the statutory auditor and in particular the provision of additional services to the audited entity.	The theme of auditor independence runs through Sarbox.
6. Non-audit services	To develop and implement policy on using the external auditor to supply non-audit services.	Included in (5) above.	The audit committee has to pre-approve any non-audit services.
7. Whistleblowing	To review arrangements regarding staff whistleblowers.	Not mentioned specifically.	The audit committee shall establish procedures for receipt, retention and treatment of complaints received regarding accounting, internal accounting controls or auditing matters, and also for confidential whistleblowing by employees.

## Appendix 3

### Test of accounting literacy

Coates et al. (2005) tested the accounting literacy of US board members. The following extracts are taken from their research paper.

We have developed criteria for financial literacy in presentations to board members. We base the criteria on the mandatory disclosure of Critical Accounting Policies and Estimates section of the Management's Discussion and Analysis section of the annual report. All the numbers in the financial statements (except the date) are estimates. Management must tell us which ones matter. We base our criteria for financial literacy on those judgements:

1. Understand the transactions that require the judgements described. [We think all board members should understand how the company earns income...]
2. Understand the accounting and measurement issues for the policies and estimates.
3. Understand management's choices among policies and methods for making estimates and the reasons behind them.
4. Understand the implications of management choices for potential manipulation of financial reporting.

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We have offered a multiple-choice quiz covering a variety of accounting and audit committee topics to attendees at Chicago GSB, Stanford Law School and Wharton multiple-day executive education sessions for board members. Over the past four years, more than 1,400 attendees, almost all board members or CEOs or CFOs or general counsel have taken this quiz. The 25-item quiz contains 13 questions whose answers are in the textbook we have used to teach first-quarter MBA students, 2 items of basic audit committee issues, and 7 items required a clear understanding of some topics currently pertinent for many companies, but advanced. ...

The median score on this quiz is about 8 correct out of 25, and this score has remained constant over several years of testing. The results point to financial illiteracy.

The financial literacy quiz included questions on the following:

Income manipulation	Deferred income taxes	Reserves
Restructuring charges	LIFO accounting	Goodwill
SEC mandates to audit committees	Derivatives	Marketable securities
Barter transactions	Mandatory reporting to audit committees	Equity method
Special purpose entities	Operating leases	Impairment of property, plant & equipment
Materiality	Retained earnings	Gains and losses on property, plant & equipment
Stock options	Issue shares for I.O.U. reserves	Deferred revenue
Purchase commitments		Asset impairment
Statement of cash flows		

## Appendix 4

# The role of the audit committee in the UK

*(Extracts from the Smith Guidance that illustrate the need for accounting, financial and auditing judgements from the audit committee)*

- 5.1. The audit committee should review the significant financial reporting issues and judgements made in connection with the preparation of the company's financial statements, interim reports, preliminary announcements and related formal statements. The audit committee should also review the clarity and completeness of disclosures in the financial statements.
  
- 5.2. It is management's, not the audit committee's, responsibility to prepare complete and accurate financial statements and disclosures in accordance with financial reporting standards and applicable rules and regulations. However the audit committee should consider significant accounting policies, any changes to them and any significant estimates and judgements. The management should inform the audit committee of the methods used to account for significant or unusual transactions where the accounting treatment is open to different approaches. Taking into account the external auditor's view, the audit committee should consider whether the company has adopted appropriate accounting policies and, where necessary, made appropriate estimates and judgements. The audit committee should review the financial reporting and consider whether the disclosures made are set properly in context.
  
- 5.11. The audit committee should review and approve the internal audit function's remit, having regard to the complementary roles of the internal and external audit functions. The audit committee should ensure that the function has the necessary resources and access to information to enable it to fulfil its mandate, and is equipped to perform in accordance with appropriate professional standards for internal auditors.
  
- 5.13. In its review of the work of the internal audit function, the audit committee should, inter alia [list is edited to highlight relevant areas]:
  - review and assess the annual internal audit work plan;
  - receive a report on the results of the internal auditors' work on a periodic basis;
  - monitor and assess the role and effectiveness of the internal audit function in the overall context of the company's risk management system.



## Appendix 5

# Extracts from the Combined Code regarding the need for directors to remain up to date

### Principle A.5 Information and professional development

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

### Supporting Principles

The Chairman should ensure that the directors continually update their skills and the knowledge and familiarity with the company required to fulfil their role both on the board and on board committees. The company should provide the necessary resources for developing and updating its directors' knowledge and capabilities.

### Principle A.6 Performance evaluation

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role.

### Higgs suggestions for good practice

Performance evaluation and the non-executive director

The Chairman and other board directors should consider the following issues and the individual concerned should also be asked to assess themselves. For each non-executive director ...

How actively and successfully do they refresh their knowledge and skills and are they up to date with:

- the latest developments in areas such as corporate governance framework and financial reporting?
- The industry and market conditions?

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