A SURVEY OF BOARD

The authors present the results of a survey that tested the financial literacy of over 150 Fortune 1000 directors.

FINANCIAL LITERACY

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In this article, we report the results of a recent survey in which we asked board members to answer questions related to their knowledge of certain areas of accounting, auditing, finance, financial-statement analysis, and corporate governance. The survey was mailed to over 1,000 board members at Fortune 1000 companies with almost 160 board members providing responses to the survey.

The survey was divided into six parts. The first part of the survey was used to gather information about the board members. Questions in this section related to the board members' educational attainment, field of study, the number of years they'd served as a board member, and the board committees on which they currently served. Additionally, the board members were asked to identify whether they were the CFO of the company on whose board they served or any other company. Finally, the board members were asked to identify their gender.

The second section of the survey was devoted to questions related to internal control and fraud. Audit committee members, under Section 404 of the Sarbanes-Oxley Act, have specific responsibility for overseeing the external auditor's efforts with regards to its report on the company's internal control over financial reporting. By definition, the internal controls over financial reporting include those controls that are in place to assure that material financial misstatements are prevented and that the company's assets are not misappropriated through fraudulent activities.

The third section of the survey included questions concerning the interpretation of financial statement ratios. Financial analysts use financial ratios in making judgments concerning a company's liquidity, financial leverage, and utilization of assets. Auditors use financial statement ratios to identify financial anomalies that could warrant further investigation. Given the importance of financial ratios for these and other reasons, board members should be knowledgeable of them and the impact management has on these ratios.

The fourth section of the survey included questions designed to measure the board members' accounting knowledge. With the advent of Sarbanes-Oxley, accounting and its application in recording the transactions affecting a firm has taken on increased prominence. Recent studies suggest that not understanding accounting has contributed to so many restatements that it "calls into question the quality of information that investors relied upon to make capital-allocation decisions." Because the board (either directly or indirectly through the audit committee) has oversight responsibility for a company's financial state-

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ments—and because many boards have been charged by the exchanges they're listed on to review major issues regarding accounting principles and financial statement presentation—an understanding of basic accounting knowledge should be of utmost importance to board members.

The fifth section of the survey included a number of questions related to the auditing of financial statements. One of the primary roles of the audit committee (or the board when an audit committee is not constituted) is its oversight of the external auditor's activities, which generally includes a review of the external auditor's audit plan and the scope of the efforts surrounding this plan. To be effective in supervising the audit, therefore, board members (and more specifically audit committees) need to have a basic understanding of certain auditing-related issues.

The final section of the survey was designed to assess the board members' knowledge of certain corporate governance issues. This section was structured primarily to assess a director's understanding of the Sarbanes-Oxley Act and its interface with corporate governance. Because the Sarbanes-Oxley Act has the force of law, board members should be expected to understand its subtleties.

The survey included fifty-eight questions. Eight of these were general background questions, four addressed internal control and fraud, six focused on financial ratios, sixteen dealt with basic accounting knowledge, three with auditing related issues, eight with finance-related issues, and thirteen with corporate governance issues.

The results

The overall score for the participants was 75%. The scores varied dramatically for each section and were generally better for the corporate governance and audit sections of the survey. For the corporate governance questions, the participant's average score exceeded 80% for eleven of the thirteen questions, while for the auditing questions average scores exceed 80% for two of the three questions.

In contrast, the overall scores for the finance-related questions fell below 80% for five of the eight questions. Additionally, the overall scores for the internal control and fraud questions fell below 80% for two of the four questions presented and scores on the financial statement ratio questions fell below 80% for three of the six questions. Finally, for the basic accounting knowledge questions overall scores fell below 80% for eight of the sixteen questions.

Questions for which overall scores were at or below 60% are identified in Sidebar 1. Thirteen questions had overall scores that were 60% or below. Most of these lower scores dealt with the finance-related questions (five of eight), followed by basic accounting knowledge (three of sixteen), corporate governance (two of thirteen), internal control and fraud (two of four), and financial statement ratios (one of six). Interestingly, none of the audit-related questions had scores below 60%.

The participants

As previously alluded to, the participants in the survey were all board members of Fortune 1000 companies. The surveys were sent to over 1,000 board members and responses were received from 157 for a response rate of almost 16%.

All but one of the responding board members had obtained at least a bachelor's degree and about half of the respondents had chosen business as a major. The majority of respondents had served on their current board for more than three years. More than half of the survey respondents were concurrently serving on more than one board. One hundred and thirty-two of the respondents were male and twenty-five were female.

In terms of their current employment, less than 10% of the survey participants indicated that they were a CFO. More than half of the participants were chairs of their respective boards and about half (seventy-seven respondents) served on the audit committee.
9. Which of the following is a characteristic of fraud?
   A. A false statement or disclosure
   B. For fraud to occur there must be injury or loss
   C. The injured party must have relied on a fraudulent statement
   D. All of the above
   52% answered this question correctly.

11. Auditors are guided by generally accepted accounting principles.
   A. True
   B. False
   10% answered this question correctly.

16. How is the inventory turnover ratio computed?
   A. Inventory / cost of goods sold
   B. Sales / average inventory
   C. Inventory / average inventory
   D. Cost of goods sold / average inventory
   48% answered this question correctly.

19. The assets reported in the balance sheet are valued for the most part based on:
   A. Current value (what a reasonably informed buyer is willing to pay for the asset)
   B. Historical cost (what the company paid for the asset)
   C. Lower of cost or market
   D. None of the above
   53% answered this question correctly.

24. When should revenue be generally recognized?
   A. When it is realized or realizable
   B. When it is earned
   C. Neither A or B
   D. Both A & B
   47% answered this question correctly.

28. Comprehensive income includes items that are not included in the firm's net income.
   A. True
   B. False
   57% answered this question correctly.

41. Historically the most expensive way for a company to finance a new investment is the
   A. Issuance of new common stock
   B. Issuance of debt
   C. Issuance of preferred stock
   D. Utilization of retained earnings
   47% answered this question correctly.

42. Which of the following does NOT have a direct influence on a company's total cost of capital?
   A. Current economic conditions
   B. The total market capitalization of the company's underlying securities
   C. The marketability of the company's securities
   D. The total amount of financing required by the company
   51% answered this question correctly.

43. Which of the following would not be considered when determining whether a company should invest in new equipment?
   A. Shipping and installation costs
   B. Changes in accounts receivable or inventory
   C. Sunk costs (cost of equipment you're going to replace)
Sidebar 2 presents questions for which overall scores were 90% or higher.

**Conclusion**

Board members hold an important position in the corporate hierarchy and are entrusted by shareholders to provide effective oversight of the company. A significant aspect of this oversight relates to the financial dealings between the company, its employees, and suppliers, as well as the communications between the company and the financial markets.

To administer their oversight responsibilities effectively, board members need to have some understanding of accounting, finance, and corporate governance issues. This article provides insight into where board members stand in terms of their understanding of these issues. For those who deal with boards, this information may prove useful in deciding the extent to which boards have an appropriate under-
QUESTIONS THAT YIELDED AN OVERALL SCORE OF 90% OR HIGHER

10. Management is responsible for maintaining an adequate internal control system.
   A. True
   B. False
   98% answered this question correctly.

12. An external audit represents an independent opinion on whether the financial statements present fairly the operations of a company.
   A. True
   B. False
   92% answered this question correctly.

18. What impact does issuing a dividend have on retained earnings?
   A. The issuance of a dividend increases retained earnings
   B. The issuance of a dividend decreases retained earnings
   C. Either A or B
   D. Neither A or B
   92% answered this question correctly.

20. Which financial statement reports your company’s income and expenses?
   A. Balance sheet
   B. Income statement
   C. Statement of cash flows
   D. Statement of retained earnings
   96% answered this question correctly.

29. Each of the following is an intangible asset EXCEPT:
   A. Patents
   B. Copyrights
   C. Secret processes
   D. Land
   99% answered this question correctly.

33. What basis of accounting is generally used when preparing financial statements?
   A. Cash basis
   B. Accrual basis
   C. Cost basis
   D. Revenue basis
   91% answered this question correctly.

39. Bonds represent a way for financing a company’s debt.
   A. True
   B. False
   98% answered this question correctly.

40. Which of the following best describes a defined benefit pension plan?
   A. A plan that has a predetermined cost to the employer
   B. A plan that gives the employee a variable benefit
   C. A plan where the account grows based on the rate of return of the underlying investments in the account
   D. A plan that specifies the amount of retirement benefit that will be distributed
   92% answered this question correctly.

50. Senior executives and financial officers are required to certify that they are or have done which of the following?
   A. Established, maintained, and regularly evaluated the effectiveness of the company’s disclosure controls and procedures
   B. Made certain disclosures to the company’s auditors and the audit committee of the board of directors about the company’s internal controls
C. Included information in the quarterly and annual reports about their evaluation and whether there have been significant changes in the company's internal controls.

D. All the above.

93% answered this question correctly.

51. For publicly traded firms, which of the following is primarily responsible for hiring or firing the external auditor?

A. The shareholders
B. Management
C. Audit committee
D. CFO

94% answered this question correctly.

53. Which person should decide what is discussed in an audit committee meeting?

A. CEO
B. CFO
C. Chair of the board
D. Audit committee chairperson

97% answered this question correctly.

57. Deficiency, as defined in the Sarbanes-Oxley Act, is any significant discrepancy in internal controls that has the possibility of adversely affecting the organization's ability to record, process, summarize and report financial data.

A. True
B. False

93% answered this question correctly.

NOTE
1 Quoted from a report by Glass, Lewis, and Co. that was the subject of the following article: S. Taub, "Restatements Surged in 2005, Says Study," (CFO.com, March 2006). The article notes that the number 2005 restatements worked out to one restatement for every twelfth company. The article is available at http://cfo.com/article.cfm/5591568/1/c_55903647#search