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Financial literacy self-assessment tool

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Deloitte's financial literacy self-assessment tool includes questions on financial accounting and reporting issues. Please note that some of the questions relate to issues faced only by SEC registrants. These multiple-choice questions are not intended to cover all topics that an audit committee member may need to understand to be considered financially literate for the company he or she serves. This tool was designed as a self-assessment for members who want to evaluate their financial literacy.

In addition to the concepts presented in the tool, audit committee members should consider whether they can answer questions on key accounting and reporting issues such as:

Do I understand the revenue recognition policy of the company?

Considerations:

- How is cash generated by the sales of the company's products and services?
- Are there significant sales to related parties? If so, are the disclosures adequate?
- Is a large portion of the company's revenue recorded at the end of a fiscal period? If so, are the cut-off procedures adequate?
- How do the company's revenue recognition policies differ from those of others in the industry?

Which amounts and balances in the financial statements are subject to the highest level of management judgment?

Considerations:

- Does the company have significant employee benefit obligations? If so, what key assumptions have been used to calculate the related liability?
- Is the company self-insured for general liability, workers' compensation, or other risks typically covered by insurance? If so, how are the reserve requirements estimated and what were the key assumptions used in the estimates?
- How does the company calculate significant reserves, such as warranty, bad debt, and inventory reserves?
- If fair value is the appropriate measure for an asset or liability, what is the process for determining fair value and how has management established the underlying assumptions?
- What criteria has management used to determine if an asset is impaired?

Are the company's disclosures adequate?

Considerations:

- What are the company's most significant accounting policies?
- Who are the company's significant related parties?
- Does the company have unique financing arrangements?
- Is the company's capital structure complex?

Deloitte has also created a self-assessment tool. Audit committees are encouraged to consider and tailor this tool as part of a broad assessment of financial literacy.

I. Financial statements and accounting literature

1. The balance sheet:
   a. Is a financial snapshot, taken at a point in time, of the assets the company owns and the claims against those assets.
   b. Records the flow of financial resources over time.
   c. Reports the operating results of a company for a period of time.
   d. Is prepared by the auditors.
   e. Both a and d are correct.

2. Shareholders' equity (owners' equity, stockholders' equity, net worth, or equity):
   a. Is a source of reserve assets consisting of undistributed income.
   b. Is the amount of cash contributed by the shareholders.
   c. Includes shareholder contributions and undistributed income.
   d. Is dependent on the company's stock price fluctuations.
   e. Both c and d are correct.

3. Basic earnings per share (EPS) is calculated by:
   a. Dividing net income by the number of common shares outstanding at the end of the reporting period.
   b. Dividing net income by the weighted average number of preferred and common stock outstanding during the reporting period.
   c. Dividing income before taxes by the number of common shares outstanding at the end of the reporting period.
   d. Dividing net income attributable to common shareholders by the weighted average number of common shares outstanding during the reporting period.
   e. Varies from company to company.

4. Financial statements to be filed with the SEC should be prepared:
   a. Following the IRS code.
   b. As the company's financing agreements dictate or prescribe.
   c. Following generally accepted accounting principles (GAAP).
   d. Using the practices followed by others in the same industry.
   e. All of the above.

5. The term “cookie jar reserve” has been used to refer to:
    a. A vehicle that allows management to smooth earnings by reducing income in good years and increasing income in bad years.
    b. Any liability or contra-asset that is larger than what management can justify.
    c. A reserve that is created using overly conservative estimates.
    d. All of the above.
6. Which of the following balance sheet items generally do NOT require management to make significant judgments and/or estimates?
    a. Inventory at lower of cost or market.
    b. Net receivables.
    c. Cash.
    d. Accrued liabilities.
    e. Both a and c are correct.
7. A company should only consolidate its financial statements with a company in which it owns 50 percent or more equity shares.
    a. True.
    b. False.
8. Which of the following is NOT true of related-party transactions?
    a. Only transactions requiring material cash payments between related parties need to be disclosed.
    b. A company cannot indicate in its financial statements that related-party transactions were consummated under terms that were similar to those that could have been achieved in an arms-length transaction unless this representation can be substantiated.
    c. The substance of related-party transactions is more important than their form.
    d. All of the above are true of related-party transactions.
9. A sale can be recorded when delivery has NOT occurred if several criteria are met, including:
    a. Risk of ownership has passed to the buyer.
    b. There is a sales commitment.
    c. There is a fixed delivery date.
    d. All of the above are required.
    e. Both a and c are required.
10. Management is required to record any adjustments that the auditors propose.
    a. True.
    b. False.
11. An amount is always immaterial to the financial statements if it is less than:
    a. 10 percent of income before taxes.
    b. 10 percent of shareholders equity.
    c. 2 percent of net assets.
    d. None of the above.

12. Financial ratios are tools that allow you to understand the complete economic picture of a company without having to understand any of its accounting policies.
    a. True.
    b. False.
13. The quick (acid-test) ratio, a tool used to assess a company's liquidity and ability to meet its obligations, is defined as:

    Current assets – Inventory ÷ Current liabilities

    a. True.
    b. False.

II. Disclosure rules

1. Which of the following does not contain financial disclosures that are subject to SEC regulations?
    a. Management discussion and analysis (MD&A).
    b. Earnings announcements.
    c. The company's financial statements.
    d. All of the above may contain financial disclosures that are subject to SEC regulations.
    e. Both a and c contain financial disclosures.
2. Which of the following financial information is covered by the independent auditors' report?
    a. Earnings announcements.
    b. Pro forma earnings releases.
    c. The footnotes to the financial statements.
    d. MD&A.
    e. All of the above.
3. Which of the following items is NOT expected to be addressed in MD&A?
    a. The most critical accounting policies used to prepare the financial statements.
    b. Liquidity and capital resources.
    c. Information that helps investors assess how current trends and uncertainties may affect the company.
    d. All of the above are expected to be addressed in MD&A.
4. Which of the following is NOT a required disclosure for a significant loan agreement under FASB codification topic 470 (formerly SFAS 47 or 129)?
    a. Interest rate.
    b. Default or breach of covenants.
    c. Name of the lender.
    d. Schedule of maturity.
    e. All of the above are required to be disclosed.
5. If a company presents permitted non-GAAP measures, such amounts:
    a. Should be disclosed along with a detailed reconciliation to, or from, GAAP amounts, and the amount of each item should be disclosed.
    b. Must have a footnote that explains in general terms how the amount was calculated—typically a formula is sufficient.
    c. Have been banned by the SEC under the antifraud provisions of the federal securities laws.
    d. Both a and c are correct.

6. Non-cash charges, such as for asset impairments:
   a. Should be ignored during most analyses, as they do not have an impact on the cash flows of the company.
   b. Should be ignored during most analyses only if they are nonrecurring charges and are not indicative of the ongoing operations of the company.
   c. Can be put "below the line" on the income statement to signal to investors that the item should be removed before analysis.
   d. Are the results of situations that may have diminished the economic value of the company.
   e. None of the above.

III. Form and content of SEC filings

1. The primary objective of the SEC is to prevent the sale of risky or speculative securities.
   a. True.
   b. False.

2. Which of the following is NOT a required SEC filing?
   a. Private equity offering.
   b. Annual and quarterly reports.
   c. Annual proxy statement.
   d. Registration statements.
   e. Both b and d.

3. Which of the following is true about the Form 10-K?
   a. Contains the annual financial statements of the company.
   b. Contains an audit report on the annual financial statements of the company.
   c. Is subject to SEC review.
   d. All of the above are true.

4. Which of the following is NOT true about the Form 10-Q?
   a. Contains the quarterly financial statements of the company.
   b. Contains an audit report on the quarterly financial statements of the company.
   c. Is subject to SEC review.
   d. Contains footnotes to the financial statements.

5. A Form 8-K is required to be filed:
   a. After a significant acquisition.
   b. After a change in auditors.
   c. A company is never required to file a Form 8-K, but companies often do so at their own discretion to notify investors of significant events.
   d. Both a and b.

6. Which of the following is required XBRL-tagged information?
   a. Financial statements.
   b. Notes to the financial statements.
   c. Financial statement schedules.
   d. All of the above.

IV. Internal control

1. Internal control is designed to provide reasonable assurance over the:
   a. Effectiveness and efficiency of operations.
   b. Reliability of financial reporting.
   c. Compliance with applicable laws and regulations.
   d. All of the above.
   e. Both b and c.

2. An effective system of internal control over financial reporting will always prevent and detect fraud.
   a. True.
   b. False.

3. Who is responsible for the design and operating effectiveness of the company's internal control over financial reporting?
   a. Management.
   b. Internal auditor.
   c. Independent auditor.
   d. The audit committee.
   e. All of the above.

4. Under the SEC's management certification requirements in Item 307 of Regulation S-K, management is required to certify that it has disclosed which of the following to its auditor and audit committee?
   a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information.
   b. The method used in designing the company's internal control framework.
   c. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.
   d. Both a and c are correct.

5. Which of the following organizations developed the internal control framework generally used by public companies in the United States?
   a. The Accounting and Internal Controls Program Administration.
   b. The Committee of Sponsoring Organizations of the Treadway Commission.
   c. The Public Company Accounting Oversight Board.
   d. The Securities and Exchange Commission.

V. Answer key

I. Financial statements and accounting literature

1. **A is correct.** The objective of the balance sheet is to present the financial condition of a company at a particular point in time.

2. **C is correct.** Shareholders' equity may include a number of other items as well, such as treasury stock and certain unrealized gains and losses.

3. **D is correct.** The calculation of basic EPS includes net income attributable to common shareholders as its numerator, not income before taxes. This calculation uses the weighted average number of shares outstanding during the reporting period as its denominator. It does not include preferred stock. Detailed guidance on earnings per share can be found in FASB codification topic 260 (formerly SFAS 128, *Earnings per Share*).

4. **C is correct.** Financial statements filed with the SEC are required to be in accordance with GAAP.

5. **D is correct.** "Cookie jar reserve" is a term that was used by former SEC Chairman Arthur Levitt to refer to accruals and other estimates used by management at some companies to manage earnings. Management should evaluate most contingent liabilities using the guidance of FASB codification topic 450 (formerly SFAS 5, *Accounting for Contingencies*).

6. **C is correct.** Many balance sheet items require significant estimates or judgments, including inventory (e.g., obsolescence reserves), accounts receivable (e.g., allowance for doubtful accounts), and accrued liabilities (e.g., warranty reserves).

7. **B is correct.** The consolidation model, as amended by SFAS 167, *Amendments to FASB Interpretation No. 46(R)*, is based on power and economics. When a company has (1) the power to direct the activities of a variable-interest entity that most significantly affect its economic performance, and (2) the obligation to absorb losses or the right to receive benefits that could potentially be significant to the variable-interest entity, it is the primary beneficiary.

8. **A is correct.** The materiality of the cash payments between related parties is not relevant to determine if a transaction needs to be disclosed. A noncash transaction between related parties also must be disclosed.

9. **D is correct.** Refer to the SEC's Staff Accounting Bulletin No. 101 and 104, *Revenue Recognition in Financial Statements*, for further guidance.

10. **B is correct.** Management is not required to record proposed audit adjustments; however, if the auditors determine that the financial statements are materially misstated, they will qualify their opinion accordingly.

11. **D is correct.** The calculation of materiality is a matter of professional judgment, considering qualitative and quantitative factors, and there is no single threshold that is applied to all companies.

12. **B is correct.** Financial ratios have less value without an understanding of the accounting policies used by a company to prepare the financial statements.

13. **A is correct.** The quick ratio is an indicator of a company's short-term liquidity.

II. Disclosure rules

1. **D is correct.** All of the items contain financial disclosures. MD&A and financial statements will contain financial disclosures and are typically presented in a Form 10-K for domestic registrants. Earnings announcements for public companies also contain financial disclosures that are subject to SEC rules and regulations, including Regulation G, *Disclosure of Non-GAAP Financial Measures*.

2. **C is correct.** Although all of these items include accounting information, a, b, and d are not covered by the independent auditors' report.

3. **D is correct.** All of these items are expected to be discussed in MD&A. Critical accounting estimates are required by Financial Reporting Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*. Liquidity and capital resources and material trends and uncertainties disclosures are required by Item 303 of Regulation S-K, *Management's Discussion and Analysis of Financial Condition and Results of Operations*.

4. **C is correct.** There is no GAAP requirement to disclose the name of the lender; however, all of the remaining items must be disclosed for each material loan agreement.

5. **A is correct.** In conjunction with the Sarbanes-Oxley Act, the SEC adopted rules governing the use of non-GAAP financial measures. Issuers using non-GAAP financial measures are required to provide, (i) directly comparable GAAP financial measures presented with equal or greater prominence, (ii) a reconciliation between GAAP and non-GAAP financial measures, (iii) a statement disclosing the reasons management believes the non-GAAP financial measures are useful, and (iv) if material, additional purposes for which management uses the financial measure. See Regulation G and Item 10(e) of Regulation S-K, Item 10, for authoritative guidance. For additional staff interpretative information on non-GAAP financial measures, refer to Topic 8 of the Division of Corporation Finance's *Financial Reporting Manual*.

6. **D is correct.** Noncash transactions are often disregarded as "paper losses," as they do not result from cash outflows; however, these transactions—for example, the write-down of a significant investment—clearly have negative economic implications to the company and in many instances require appropriate disclosure.

III. *Form and content of SEC filings*

1. **B is correct.** The SEC's primary mission is to protect investors and maintain the integrity of the securities markets. Its focus is to provide timely and accurate information for investors to make informed investment choices, not to restrict risky or speculative issuances.

2. **A is correct.** All of the remaining items are required SEC filings.

3. **D is correct.** A Form 10-K is an annual report that contains the financial statements of a public company and the financial statements included in the filing are required to be audited by an independent registered public accounting firm. The SEC is required to review each registrant at least once every three years, but the SEC staff is not required to issue a comment letter for all reviews. Therefore, Form 10-Ks are subject to SEC review.

4. **B is correct.** A Form 10-Q is a quarterly report that contains the financial statement of a public company. Although the financial statements included in the Form 10-Q must be reviewed by an independent registered public accounting firm, the firm is not required to audit the interim period. Further, the firm is not required to issue a review report, and even if a review report is issued, it is not required to be included in the Form 10-Q. The SEC is required to review each registrant at least once every three years, but the SEC staff is not required to issue a comment letter for all reviews. Therefore, Form 10-Qs are subject to SEC review.

5. **D is correct.** The instructions to Form 8-K require public companies to file Form 8-Ks when certain events occur. Those include significant acquisitions and changes in auditors.

6. **D is correct.** Financial statements, notes to the financial statements, and financial statement schedules are all required to be XBRL-tagged information for certain SEC registrants. The SEC's final rule on XBRL permits, but does not require, registrants to tag each qualitative (narrative) disclosure. It also states that tagging of MD&A disclosures is "neither required nor permitted" and that the SEC will "continue to consider, however, the advisability of permissible optional or required interactive data for disclosures made outside a set of financial statements prepared in accordance with U.S. GAAP." The requirement is being phased in.

IV. Internal controls

1. **D is correct.** Internal control is broadly defined as a process, affected by an entity's board of directors, management, and other personnel, that is designed to provide reasonable assurance regarding achievement of objectives. From the perspective of preparing financial statements, answer b is applicable. The SEC states that "internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that—
    a. Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
    b. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
    c. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements."

2. **B is correct.** An effective system of ICFR should provide reasonable assurance that material misstatement of the financial statements due to fraud and error will be prevented or detected, but cannot provide absolute assurance.

3. **A is correct.** For public companies, Item 308 of Regulation S-K requires management to explicitly state responsibility for ICFR in a Form 10-K filing. Also, under Section 404 of the Sarbanes-Oxley Act of 2002, management is required to certify its responsibility for establishing and maintaining adequate ICFR in periodic filings.

4. **D is correct.** SEC regulations require disclosure of both a and c. Management must certify that it has communicated fraud, whether or not material, as well as significant deficiencies and material weaknesses in the company's ICFR to its auditor and the audit committee. B is a requirement under Section 404 of the Sarbanes-Oxley Act and pertains to management's annual ICFR report. It is not a requirement under Rule 302.

5. **B is correct.** The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is an organization dedicated to improving the quality of financial reporting through effective business ethics, corporate governance, and internal controls. This committee has issued the *Internal Control – Integrated Framework* and other guidance, including *Guidance on Monitoring Internal Control Systems*, on implementing the framework.

Commitment to effective corporate governance

Deloitte has a number of programs and initiatives that demonstrate its commitment to helping boards and audit committees enhance their effectiveness and overall corporate governance.

Center for Corporate Governance

The Deloitte Center for Corporate Governance is a resource for executives, directors, and the governance community on the latest and most relevant corporate governance trends, regulations, and leading practices. The center generates research and roundtables on current boardroom issues and conducts periodic Dbrief webcasts on governance topics. The **Center for Corporate Governance website** at **www.corpgov.deloitte.com** offers timely, relevant, and balanced governance information for boards of directors, senior executives, investors, and others interested in governance.

Governance services

Deloitte governance services include board evaluations, board and committee practice benchmarking, and in-the-boardroom director development programs. Services draw on the full range of Deloitte's experience in areas critical to board effectiveness. To learn more, contact your Deloitte partner or e-mail us at **corporategovernance@deloitte.com**.

For more information

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