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Profit or Cash?

What will a lack of financial knowledge cost your organization?

Picture the scene. It's a meeting of a business organization and the Finance Director (FD) is briefing everyone on the latest financial information. His presentation complete, he asks for questions; there are none. The meeting moves on to the next topic. Yet has anyone realised why there may not be questions for the Finance Director, let alone answers to financial questions from the FD?

An article from the October Harvard Business Review gives a clue[1]. In a recent survey of over 300 US business people, a majority showed a woeful lack of financial knowledge. Over half could not define the difference between profit and cash. (And if you didn't know there was a difference, please read on). Many could not tell the difference between a Profit & Loss Account and a Balance Sheet (yes, like the difference between a video and a photograph). Two thirds did not realize that Discounts have a negative effect on Gross Margin.

Three questions from the Berman & Knight Study:

1) You should be pleased about your company's results if:
   - a) There is a negative trend in operating margin
   - b) There is an increasing trend in COGS
   - c) Cash flow is coming from company operations
   - d) Cash flow is coming from company investing

2) A company has more cash today when:
   - a) Customers pay their bills sooner
   - b) Accounts receivable increases
   - c) Profit increases
   - d) Retained earnings increases

3) To investors and Analysts, free cash flow is a key number because:
   - a) It reflects that cash is "free" – no interest is payable
   - b) It has cash that can be used to pay shareholders their dividends
   - c) It reflects the operating cash that has flowed into the business in the current year
   - d) It is the cash that investors have put into the business

The approximate proportion of managers getting the correct answers: 1) 52% 2) 26% 3) 30%

The article concludes with an interesting reflection of attitudes to finance in today's organizations. "Most people don't ask because they don't want to appear uninformed in front of their boss or peers". From the figures in the survey, many should not worry - their boss or peers may not know either.

And the answers: 1) c 2) a 3) b

This study provides interesting evidence that backs up our own anecdotal feedback from our Finance for Non Finance managers Course. This program coincidentally includes a Finance quiz which is used to determine what existing level of knowledge our delegates arrive with, and also as a basis to explain some financial terminology.

The content of our quiz is tailored to the audience - little point in asking service businesses about stock management - yet we have found a similar pattern. In the last 4 programs I have run, average marks run around the 50% level.

Three questions from our own Introductory Finance quiz[2]:

Which of the following is the best definition of Working Capital?
- A) The capital raised by shareholders
- B) Shareholders equity plus long-term borrowing
- C) The total assets of the business
- D) The amount by which current assets exceed current liabilities

Which of the following is the "bottom line"?
- A) Gross Profit
- B) Retained Earnings
- C) Equity Income, Net of tax
- D) Operating income

Share Capital $1.5m, Long Term Debt $500,000 Retained Earnings $500,000 Operating Income $500,000. What is the Return on Capital?
- A) 33%
- B) 100%
- C) 20%
- D) 66.6%

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So why is there such a lack of financial knowledge?

Interestingly, the November issue of HBR may provide a clue. In a separate article[3] another danger is highlighted, that many people cannot and do not understand their credit card bills.

In answer to the question "How long does it take a debt to double at a 20% compound annual interest rate, with no payments?", only 36% of all adults chose the correct answer (which if you think you may be in the remaining 64%, is less than two years).

It seems that lack of financial literacy is not confined to work issues, and neither will they be confined to the US. In the UK the Financial Services Authority has since inception had a remit to improve financial knowledge. Yet this is aimed at preventing repeats of endowment policy miss-selling and other financial services misdemeanors, rather than a financial literacy issue.

A similar (and on first impressions, more effective) initiative has recently been launched in Canada - Financial Literacy in Canada, by the Minister of Finance (http://www.financialliteracyincanada.com)

The possible consequences of this lack of financial literacy are worrying. Finance Directors may be thinking they don't get asked questions because people are not interested, but in the wake of Enron and other scandals people should be in a position to ask financial questions.

Many organizations plan their business using a Balanced Scorecard approach - which if these surveys are representative, may be balanced but at best only three quarters understood.

Why is finance not understood? Firstly it is not always taught in school, and even when it is, not always well regarded. But we cannot place blame just with the education system.

From my own experience, I would suggest there are three perceptions about finance which are preventing people from being able to understand and contribute to their organizations (and their own) development:
Its Dull, Its Difficult, and someone else Does it.

These Three Ds summarise much about perceptions of what happens when the finance people speak, or have to be spoken to. Finance is very easy to leave to the "Finance people" when you think it won't interest you and that even if it did, you couldn't cope with it.

Yet there is no reason why we should not know more. A interesting analogy came to me by way of my daughter's Maths teacher. When it comes to Maths (and maybe finance) many people think "I can't do it". Yet take driving - how many people think "I can't do it"? Most expect to drive, and take lessons until they have proved they can.

There's even a test! The Three D's do not appear when it comes to driving, and many other aspects of life. So there is no logical reason for this perception with finance.

The Three Ds also guide the delivery of our Finance programmes, in that we design our training to face these perceptions. Use of real and relevant case studies, linked to real life stories about the organizations, ensures that finance becomes relevant for managers at all levels.

Looking at the financial position of competitors also helps in this regard. We also make finance easy by using a range of learning methods, enabling discussion of principles, and helping managers use the figures most relevant to them. Finally, we design training for the Non Finance manager, so they do not have to be a book keeper, but become able to discuss financial performance with the Finance Director and not feel in fear of showing their ignorance.

Before your next management meeting, remember: there are three types of managers: those who can count, and those who cannot. More seriously, if you would like to find out about the levels of financial literacy in your organization, we can help you with our own short Financial Literacy Test, and the training to improve financial knowledge.

This means Finance Directors have more questions asked of them - but the ones I speak to enjoy that! And the Managers will too.

[1] Are Your People Financially Literate? By Karen Berman & Joe Knight HBR October 2009

[2] We think: 1) d 2) b 3) c

[3] Teach Workers About the Perils of Debt by Annamaria Lusardi & Peter Tufano HBR November 2009

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