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BUSINESS TALK 101

If you don't know your income statement from your cash flow statement, you're not alone. An alarming number of business leaders are ignorant of the simplest financial terms. Recent studies have shown that without a basic grasp of business literacy, employees are limited in their ability to contribute to an organisation's success. Educating them in the jargon of the pink pages, however, can have a positive effect on a company's balance sheet.

TEXT ROSS TIEMAN ILLUSTRATION ROBI INSINNA

BUSINESS LEADERS ARE LOATH TO ADMIT THEIR POOR GRASP OF BUSINESS JARGON

BANKRUPTCIES IN THE US DEMONSTRATE THE PERILS OF FINANCIAL ILLITERACY

You don't have to be a master of financial concepts to succeed in business. Indeed, the number of business leaders ready to admit their ignorance of even the most basic financial concepts is startling while more still are loath to admit their poor grasp of the jargon that litters the pink pages of the world's newspapers.

Most of this world's entrepreneurs are neither accountant nor business studies graduates. They have had to learn the language of business along the way – and it's not easy.

But these days, it is not just the bosses who need to be business literate. Companies are demanding that employees understand how business works, our personal finances and investments are becoming more complex, and more of us are starting businesses of our own.

Understanding the terminology and methods of business has become an imperative for all. Yet many of us are struggling.

A study by the Securities and Exchange Commission (SEC) found that in America, the supposed paradise of entrepreneurship, only half of all adults and a third of high-school students could pass a basic financial literacy test.

And I mean basic. Almost two-thirds of students did not know that in times of inflation, money does not hold its value. Only 58 per cent of students understood that when demand for a product goes up but the supply doesn't, its price is likely to increase.

Moreover, almost 50 per cent of the adult population and two-thirds of students did not know that a stock market brings together people who want to buy stocks with those who want to sell them. Would ordinary people in Europe, Asia, or Latin America score any better?

The perils of financial illiteracy among a population with more and more personal wealth to manage are amply demonstrated by the level of personal bankruptcies in the US. The trend has been rising inexorably since 1977, and in 1997 reached 1.3 million in a single year. Now consider this. The same nation that fails to grasp the basic principles of markets, supply and demand and inflation has been pouring ever-larger sums into the stock markets. ▸▸

BUSINESS LITERACY IN AMERICA

AMONG US STUDENTS

- Two-thirds of American high-school students, and nearly half of all adults, failed a test of basic economic literacy
- Almost two-thirds did not know that in times of inflation, money does not hold its value
- Only 58 per cent of students understood that when demand for a product goes up but the supply doesn't, its price is likely to increase
- Almost half of adults and two-thirds of students did not know that a stock market brings together people who want to buy stocks with those who want to sell them
- Thirty per cent of US high-school students thought retirement income from a company is called social security
- Only 14.6 per cent thought stocks would achieve a higher growth rate over 18 years than savings accounts, cheque accounts or government bonds

AMONG US INVESTORS:

- Only 38 per cent know that when interest rates rise, the price of bonds usually falls
- 45 per cent mistakenly believe that diversification guarantees that their portfolio won't suffer if the market falls
- Only 5 per cent believe they know enough to make good investment decisions
- 60 per cent say they know "just some" or "very few of the things necessary" to make good investment decisions

Source:
US Securities and Exchange Commission

In the US, a quarter of household assets – USD11 trillion – is invested in the stock market. In 1998, securities accounted for 77 per cent of US households' liquid financial assets, with 44 per cent in stocks, 17 per cent in mutual funds and 16 per cent in bonds and money market funds.

Assets held in US mutual funds grew from USD135 billion in 1980 to more than USD5.5 trillion in 1998. And it isn't just the rich, or financially sophisticated, who have been putting their hard-earned savings in the market.

Sure, the well-heeled are more likely to use the markets. According to the SEC, 84 per cent of US households with an income of more than USD100,000 a year own securities, and among those with an income of USD50,000 to USD99,000 the percentage was 66 per cent. But fully a quarter of US households earning less than USD25,000 a year also owned securities.

This same trend is now visible in Europe. In Britain a quarter of household assets is reckoned to be held in stock-market related investments, while in continental Europe the proportion of private shareholders has risen with every successive privatisation of state assets. In the past few years, even Europeans on modest incomes have been playing the markets, whilst in Asia investment has rivalled gambling as a speculative pastime.

Many of these investors are ill-equipped to assess the merits of the funds and equities they are buying. A US study by the Investor Protection Trust concluded that "less than a fifth of investors surveyed are truly literate about financial matters specifically related to investing. Most lack basic knowledge about the meaning of financial terms and about the way different investments work".

And we have seen the consequences. Last year's internet bubble was surely the most graphic example of what Federal Reserve Board chairman Alan Greenspan termed the "irrational exuberance" that had come to characterise the world's stock markets.

MANY INVESTORS ARE ILL-EQUIPPED TO ASSESS THE MERITS OF THEIR PORTFOLIO

Private investors in the US, Europe and elsewhere have been pouring money into mutual funds and the shares of individual companies. But many of these investors – a majority if the US evidence is anything to go by – do not know enough to make a rational evaluation of the merits and demerits of their investments.

They do not even possess the most basic tools for assessing the relative "optimism" reflected in a particular share price, such as the price-earnings ratio or yield. They cannot judge a company's efficiency by looking at its return on capital employed, or even its return on sales – let alone spot an emerging cash-flow difficulty.

So what drives their buying and selling decisions? Instinct? Rumour? Gossip? Newspaper share tips? Apparently so. That would begin to explain why shares in fashionable internet companies were driven up to extraordinary heights last year whilst those of "old economy" stocks languished.

For as we have seen, the sums invested in the world's stock markets by private investors are now enormous. So large, indeed, that it is now often amateur, unskilled investors, rather than market professionals, who collectively set the value of many stocks.

That readily leads to over-valuations with the consequence that when professional investors, who understand the fundamentals, conclude that prices have gone too far and start pulling their money out, small investors get their fingers burnt.

Between the fourth quarter of 1999 and the final quarter of last year, the value of US household investments in equities slumped from USD8.75 trillion to USD6.58 trillion. In the same period, the NASDAQ Composite index, a snap-shot of the value of quoted American high-tech companies, fell 39.29 per cent as the markets began to correct inflated share prices. Many private investors were almost certainly caught out by the correction. For these financial illiterates, ignorance had a high price.

But there are wider consequences to be reaped from this misdirection of resources into over-priced assets that yield money hand-over-fist on the unproven presumption that one day they would make a good profit. Bubble companies with inflated stock market valuations and unproven management were able to take over soundly-run businesses that had ▸▸

THE WORDS OF AN EXPERT

"This is something I feel really passionately about," says Karen Berman, founder of the California-based Business Literacy Institute.

"During my research as an organisational psychologist, I found that companies were asking employees to get involved, but employees often didn't understand the measures, such as cashflow and financial ratios, that companies were using."

"It is not that employees are not smart. They just never had an opportunity to learn these things."

Nor were the bosses necessarily much better. "What happens most of the time is that people don't want to look stupid, say, in a management meeting, so if they don't understand something, they keep quiet.

"We have, on many occasions, run into management teams that are not really comfortable with their level of business literacy."

And if middle managers don't properly understand the company's financial measures, it is no wonder that many employees fail to identify with their employer's aims, or understand how they can influence its financial performance.

"Teaching employees at all levels basic business literacy, and showing them how financial measures relate to what they do, has a proven pay-off," says Ms Berman.

The institute's research shows that companies with financial literacy programmes typically report improved employee trust, better cashflow, higher profits and a fall in expenses.

failed to attract speculative investors – often leading to the destruction of value for shareholders.

Meanwhile, sectors of the economy enjoying attractive markets and good returns were finding it hard to raise capital. As the Federal Reserve Bank of Minneapolis concluded, the consequence of economic illiteracy is a misallocation of resources across the whole economy. And as consumers, we pay for it – and not just through higher prices.

Another effect of our financial illiteracy is that many of us fail to realise just how much we must save to enjoy a comfortable retirement, and don't make adequate provision. But it also has an impact within the workplace. And while investment watchdog bodies and high schools have started business literacy programmes with a view to educating investors, or encouraging better personal financial planning, some businesses are now taking steps to develop financial literacy among their employees.

Business interest arose almost by accident. As competition has increased, automation has slimmed the blue-collar workforce, and average company size has declined, managers have been sharing more information with employees. The idea is that if workers understand financial ratios, and the part they personally play in the company's profitability, they will be able to deliver more value for shareholders.

The spate of mega-mergers during the late 1990s accelerated the process. International super-groups such as Anglo-Swedish pharmaceuticals company AstraZeneca and Italian chemicals group Enichem have been trying to create a single corporate culture in which employees identify with corporate aims across international boundaries. And both are among the rising number of companies that have resorted to business literacy programmes to help employees understand what they are talking about.

COMPANIES THAT TEACH BUSINESS LITERACY SKILLS SEE CLEAR BENEFITS

EMPLOYEES TAKE WHAT THEY LEARN AND APPLY IT TO THEIR PERSONAL FINANCES

Typically, such programmes focus on explaining the company's income statement, the difference between profit and cash, and the key operational measures – varying from company to company – that a particular employee can affect by his or her performance.

According to Karen Berman, director of the California-based Business Literacy Institute, companies that have made an effort to develop the business literacy skills of their employees see clear benefits.

A follow-up study of US companies with business literacy programmes found that 91 per cent reported improved internal communications, 71 per cent more trust among employees, and 61 per cent said staff were happier in their work.

On the financial front, 74 per cent said expenses fell, 86 per cent said cashflow improved, 66 per cent reported higher profitability and 71 per cent said other financial measures showed improvements in the running of the business.

The scale of improvements was not quantified, but they nonetheless establish that there are benefits attached to employees knowing what their managers are talking about. And its not just the company that benefits. Several studies have shown big improvements in employee well-being after financial literacy programmes. People take what they have learned and apply it to their personal finances.

The result? They manage their money better, save more, and suffer less stress about their finances. And since money is one of the biggest causes of worry in people's lives, they become happier (as well as more productive at work).

That's a pretty strong incentive to wise up. Newspapers, websites and textbooks all offer impartial insights into understanding business, so why wait for an employer to teach you business literacy? After all, there will be times when the company's interests are markedly different from those of the individual. In a business-oriented world, better understanding may or may not make us richer, but it should help us avoid financial pitfalls. Forewarned, as they say, is forearmed. ■

TEST YOUR BUSINESS LITERACY

Question: What is the difference between profit and cash?
Answer: Profit is calculated based on promised revenues matched with expenses related to those revenues. Cash is the actual dollars in the bank. Revenue (and profit from revenue) is recorded when a product or service is delivered, not when the cash is received. You can show profit from a sale, but cash might be tight until the customer actually pays the bill.

Q: When a company is said to be a USD700-million company, what does this mean?
A: It means that the company's sales are USD700 million (not profit and not cash in the bank).

Q: When businesspeople talk about high-margin and low-margin industries, what do they mean?
A: Margin is the percentage of revenue that is kept as profit. Think of it as how many cents of every sales dollar is kept as profit. A low-margin company might keep just one or two cents of every dollar. A high-margin company might keep 20 cents or more of every sales dollar. For example, grocery stores are a low-margin industry; television is a high-margin industry.

Q: Which document, an income statement or a balance sheet, shows a company's holdings at a specific point in time?
A: The balance sheet shows a company's assets, liabilities and equity at a particular point in time.

Q: What does return-on-investment (ROI) tell you?
A: ROI, calculated by dividing pre-tax earnings by average investment, tells you the rate of return you can expect from your investment in a piece of equipment, project, or training programme. You can then compare that rate of return to other potential projects, pieces of equipment, and investments.