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Harvard Business Review

Are Your People Financially Literate?

by *Karen Berman and Joe Knight*

Senior executives routinely share and discuss financial data with marketing directors, operations chiefs, and other direct reports. But how much do those managers really understand about finance? We recently investigated this question, and the news is not good.

Asked to take a basic financial-literacy exam—a test that any CEO or junior finance person should easily ace—a representative sample of U.S. managers from C-level executives to supervisors scored an average of only 38%. A majority were unable to distinguish profit from cash. Many didn't know the difference between an income statement and a balance sheet. About 70% couldn't pick the correct definition of "free cash flow," now the measure of choice for many Wall Street investors. (See the sample questions below.)

Does this lack of financial literacy matter? From individual managers' point of view, it surely does. Those who can't speak the language of business can't contribute much to a discussion of performance and are unlikely to advance in the hierarchy. They may be caught off guard by financial shenanigans, as many employees at Enron were. They will be unable to gauge the health of a prospective employer. One of us, Joe Knight, serves as the chief financial officer of a small manufacturing company. He often asks candidates for engineering positions whether they would like to review the past two years of the company's financials. None yet have taken him up on the offer—knowing, perhaps, that they could make neither head nor tail of the statements.

Financial illiteracy in the managerial ranks can be a crippling weakness for the organization, as well. Imagine a business that is attempting to increase operating cash flow, as many firms are at the moment. Even experienced executives, accustomed to managing a P&L, may be unaware of the many balance-sheet levers they can pull to affect cash—decreasing inventory, for example, or reducing days sales outstanding.

We recently worked with a health care services company seeking to increase its gross margin, and the first thing we had to do was help the sales force understand the difference between making a sale and making a profitable sale. Unfortunately, that's a widespread problem. Nearly two-thirds of our test takers thought that discounts offered by sales reps had no effect on gross margin. If you don't understand what goes into a number, you can hardly know how to improve it.

Why don't people tell their bosses that they don't speak finance? It's the usual human reluctance to admit ignorance. In a survey of a different sample of managers, we asked what happens in meetings when people don't understand financial data. The majority chose answers reflecting that reluctance, such as "Most people don't ask because they don't want to appear uninformed in front of their boss or peers."

 Financial IQ Test (Located at the end of this article)

Financial IQ Test

We developed a 21-question exam called the Financial IQ Test with colleagues at Alliant International University's Marshall Goldsmith School of Management and then administered it to a random sample of more than 300 U.S. managers.

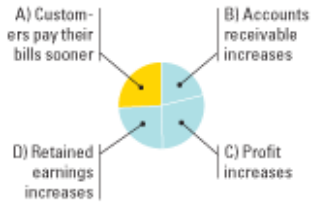
Here are selected questions, along with the answers given by respondents (pie slices indicate proportion of respondents giving each answer).

You should be pleased about your company's financial results if:

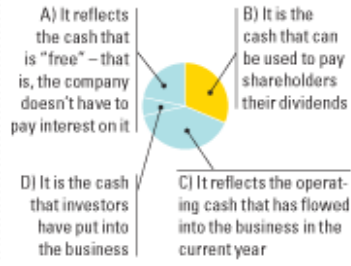


■ Indicates correct answer

A company has more cash today when:



To investors and analysts, free cash flow is a key number because:



Jesse Leikowitz

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