

MANAGEMENT BY THE NUMBERS: USING FINANCIAL STATEMENTS TO IMPROVE BUSINESS PERFORMANCE

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Luca Pacioli, an Italian Friar from the 15th century A. D., is credited with having invented the double entry accounting system. It's been driving business owners crazy ever since.

The modern version of the three basic financial statements derived from this system include the profit and loss, or income statement, the balance sheet and the cash flow statement. Each of these, or at least the first two, are routinely prepared following the end of each calendar month by countless accountants around the world and, all too often, are then promptly filed away. In fact, these reports, which many business owners use solely for purposes of filing their tax returns, can provide a fountain of information about the operations of a company.

Financial statements measure your business' economic performance. Obviously, if your accounting system is not competently managed, these measurements will be erroneous, unreliable and of little use to anyone. Therefore, the first step in establishing a system to use this information begins with making sure that the person responsible for maintaining your accounting system is properly trained and experienced.

Once you have established that the financial statements are reliable and accurate, the second step is to learn how to decipher them. This will probably require some training and minimally involves understanding the basis concepts of profit and loss, how various "metrics" or ratios are developed, and most importantly, the actual business activities that affect them. This training may be acquired from a variety of sources including formal educational institutions, books, seminars and business advisors.

The third step is to develop management systems, such as an operating budget, which allow you to establish the standards for these various metrics and provide methods by which they may be compared to actual results. A simple example would be determining through the budgeting process that an annual net profit margin of 10% for your company is desirable and attainable. This standard is then compared to the actual

profit margin at the end of each operating period. If you are on or over budget, congratulations are in order. If not, then a review of the numbers that affect this ratio can identify the business activities that caused you to miss your goal.

No single financial ratio can meet the analytical needs of any particular business. In fact, there are four primary groups of ratios that have been developed. They include those related to liquidity, or your ability to pay your bills; activity ratios, which can help manage inventory and trade payables, for example; financial ratios, which focus on your use of leverage; and profitability ratios.

Running a business without the ability to use your financial statements is not unlike driving down the highway in a rain storm with no windshield wipers. Once you turn those wipers on, you'll never want to be without them again.

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