

Benchmark-One™ Series

Inadequacy of Financial Statements as a Management Tool

The financial status of business changes with every transaction. For example, when a sale is made for say, \$100, inventory is reduced by the cost price - say \$50, cash or (accounts payable) increases \$50 and profit also increases \$50. Every expense paid such as wages or rent etc reduces cash and reduces profit. Payment for transactions that do not directly impact profit other than through depreciation, such as buildings or vehicles etc reduce cash and increase assets.

Depending on the type of business, there could be hundreds or thousands of such transactions impacting the assets and liabilities of the business as represented on a balance sheet statement, but adjusting the statement after every event would be rather like viewing a film frame by frame. So all transactions are captured under identifiable labels known as ledger accounts, and the balance sheet is adjusted at the end of month, or quarter or in most cases, annually.

Transactions impacting profit are brought together in the profit and loss statement. The cost of purchased goods or materials used during the period together with the expenses of the period are deducted from the value of sales. The resulting profit - or loss - is then taken up in the balance sheet .

Given the two compliance¹ driven statements of balance sheet and profit & loss represent the prime information available to the vast majority of small medium enterprises, what do they reveal about the relationship of available resources to capacity or volume output?

“I put 25% on every transaction to cover profit but never seem to get more than 5% at the end of the day. What am I doing wrong?” asked the proprietor. Despite a comparison of actual with budget, the latter developed by adding 10% to sales and 3% to expenses of the previous year, there was nothing in the financial statements that would meaningfully answer the question or resolve his problem².

In the next FAQ, we learn how resolution of the problem opens the doorway to a new and more profitable way of doing things.

¹ Compliance-driven refers to statutory demands by taxation and other regulatory authorities.

² The question was asked following a period of negative outcomes. It should also be asked when the outcome is positive so that parameters can be set to repeat the result. In fact, as we shall see, a bad outcome invariably has very positive transactions mixed with the bad, but due to a lack of understanding of the issues involved, the bad is allowed to predominate.