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Setting Up Your Own Business: Glossary of Financial Management Terms

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If you have ever sat down with an accountant or banker, you quickly learn that they have a language all their own. This glossary is designed to help you understand some frequently used words in what sometimes is called, "the language of business." Being familiar with the terminology can help you become more comfortable and effective in communicating with accountants, lenders, suppliers, and others in the business community.

The words defined here are drawn from accounting, economics, and finance. While these short definitions will help you understand meanings, they are not meant to be elaborate explanations. If more detail is needed, consult business publications in your local library or bookstore.

General business and finance terms are defined first. Definitions of financial statement terms follow. They are grouped under balance sheet, income statement, and cash flow statement headings. In instances where a definition applies to more than one term, the alternate terms are identified.

Business and Finance Terminology

Accounting period — The period between successive closings of the books of a business. An accounting period typically is a month, three months (a quarter), or a year (a fiscal year or a calendar year) corresponding to the tax year used by the business.

Accruals — Amounts owed to or owed by a business that have not yet been recorded in the books of the business.

Accrual-basis accounting — In accrual-based accounting, revenues are recorded at the time they are earned (payment may be received in another period); and expenses are recorded when incurred (often not in the period when they are paid).

Amortization — The reduction in the value of an intangible asset (a copyright, a patent, an address list, or other similar property) taken as an expense (written off) in each accounting period. (Compare to **loan amortization**, defined below.) NOTE: For a tangible asset, it is called depreciation.

Assets — All valuable resources, properties or property rights owned by a business or a person.

Business net worth or **business equity** — The owners' interest in a business. Equity is calculated as the value of all business assets minus all business liabilities. (Often called **owners equity** or **owners net worth**.)

Business liabilities — Everything (all debts) owed by the business.

Cash-basis accounting — An accounting system in which revenues are recorded when received or collected, and expenses are recorded when paid.

Change in net worth — Change in business net worth during an accounting period due to business earnings during the period. Usually calculated from a cost-basis balance sheet (see definition under "Balance sheet terminology") holding unit value of inventories constant. (Sometimes called **comprehensive income**.)

Depreciation — The book entry reduction in the value of a tangible asset (buildings, equipment, vehicles, inventory, etc.) attributable to age, wearing out, and/or obsolescence.

Depletion — The book entry reduction in the value of a natural resource asset due to "using up" the natural resource. For example, the using up (depletion) of gravel deposits, petroleum reserves, or other natural resource property.

Distributions to owners — Distributions of business funds to the owners of a business. (Also called **withdrawals, monthly draw**, or **draw**.)

Expenses — Costs incurred for business purposes during an accounting period. (Costs incurred in connection with earning revenues.)

Loan amortization — The schedule of payments to be made in repaying a debt. With **level-payment amortization**, the payment amount is constant throughout the repayment period. With **constant-principal payment amortization**, the amount of principal repaid in each payment is constant but the interest amount and the total payment amount decline as the principal balance of the loan is reduced.

Losses — Decreases in equity (net worth) of a business due to expenses greater than revenues.

Operating revenues — Inflows of funds from sales of goods or services offered for sale through the principal business activities of a business.

Nonoperating revenues — Inflows of funds from all sources other than operating revenues.

Sales — The dollar value of goods and services sold during a specified period after making adjustments for returns, credits, and discounts.

Balance Sheet Terminology

Accumulated depreciation — The total of depreciation amounts taken since the time a depreciable asset was put in service. (Charges for depletion of natural resources and amortization of intangibles also are accumulated and reported on the balance sheet.)

Business balance sheet — A financial statement providing a "snapshot view" of the financial condition of the subject business on specified date. The three principal divisions of a balance sheet are: assets, liabilities, and net worth (equity). (Also called a **financial statement**, a **net worth statement**, or a **statement of financial condition**.)

Cost-basis balance sheet — A balance sheet in which asset values are entered at cost or cost less depreciation, amortization, or depletion (as appropriate to the type of asset). (Also called a **book-value balance sheet**.)

Current ratio — A liquidity ratio measuring the ability of a business to pay its current obligations when due. The current ratio is calculated by dividing total current assets by total current liabilities. Most managers and lenders want the current ratio to be 2.00 or greater.

Debt ratio — A solvency ratio measuring the total debt level of a business. The debt ratio is calculated by dividing total liabilities by total liabilities plus net worth. Values greater than 1.0 indicate the business has negative net worth (is insolvent).

Market-basis balance sheet — A balance sheet in which assets are valued at their respective market prices assuming a reasonable time period for their sale.

Quick ratio — A liquidity ratio measuring the ability of the firm to pay its current obligations without liquidating inventory. The quick ratio is calculated by dividing total current assets minus inventory by total current liabilities. (Also called the **acid-test ratio**.)

Business Asset Terminology

Current assets — Cash and other assets that normally will be sold or used up within one year. Categories include: cash, marketable securities (value is lower of cost or current market), receivables, inventories, prepaid expenses, and time deposits that mature within the accounting period.

Intermediate-term assets — Assets that normally will be sold or used up during a period of one to five years. Categories include: vehicles, machinery, and equipment (may be placed in personal property category); breeding livestock; securities not readily marketable; and other similar assets. The cash surrender value of life insurance policies sometimes is included.

Fixed assets — Assets with expected lives greater than intermediate-term assets and not expected to be sold in the foreseeable future. Categories include: land, natural resources, buildings and fixed equipment, patents and other intangibles, and securities held as investments. If not entered as intermediate-term assets, the cash surrender value of life insurance. (Also called **long-term assets**.)

Other assets — Assets that do not "fit" in the above categories. Examples include some prepaid long-term expenses, deposits on long-term leases, and intangibles not directly in use by the firm.

Business Liability Terminology

Contingent liabilities — Liabilities that will be incurred only when assets are sold. Contingent liabilities include selling costs for assets, income tax on capital gains realized through the sale of assets, and write-off of the unrecovered value of intangibles or natural resources.

Current liabilities — Debts or accrued amounts owed that are to be paid within a year. Current liability categories include accounts payable, notes payable, taxes payable, current portion of principal on intermediate-term or long-term debt, cash dividends payable, accrued interest and other accrued liabilities.

Intermediate-term liabilities — Debts to be paid after the current year or accounting period but within the next five years. (The number of years usually is the same as for intermediate-term assets.) Typical intermediate-term liabilities include debt on machinery, equipment, vehicles; buildings and building remodeling, fixtures, breeding livestock, and operating capital to be repaid over two or more years.

Long-term liabilities — Depending on the nature of the business and the proprietor's intent, may be debt with an extended repayment period such as a many-year mortgage on land and buildings, or debt that's intended to be permanent such as bonds issued to investors. (Also called **long-term debt** or **fixed debt**.)

Income Statement Terminology

Accrual-basis income statement — An income statement compiled from accrual-basis accounting. Revenues are credited

in the accounting period when earned; expenses are charged in the accounting period when incurred. Compared to other types of income statements, the accrual-basis income statement usually gives the most accurate measures of income or loss.

Cash-basis income statement — An income statement compiled from cash-basis accounting. Revenues are credited when received or collected; expenses are recorded when paid. A cash-basis income statement does not match current costs with current revenues. It can give erroneous measures of profit or loss when inventory levels increase or decrease during the accounting period.

Gross profit — The excess of net operating revenues (sales less discounts and returns) over the net cost of goods sold (cost of purchases less discounts and returns).

Income statement — A financial statement that identifies business profit or loss over a specified period of time, usually a year or other accounting period. (Also called, a **profit and loss statement**, or a **P&L statement**.)

Operating expenses — Expenses incurred in paying for the day-to-day activities of the business.

Operating profit (loss) — Income or loss before taxes calculated as the difference between total revenues and total expense, disregarding the effects of any extraordinary transactions. (Also called **net income**.)

Cash Flow Statement Terms

Cash flows — All dollar amounts received by or paid by the business. All monetary flows into or out of the business.

Cash flows from financing — Cash flows related to the use of credit by the business as it prepares for, engages in, or terminates business activities. NOTE: These "cash flows" include both debt extensions and debt repayments during the subject accounting period.

Cash flows from investing — Cash flows from transactions involving purchases and sales of productive assets and the debt and equity instruments of other firms.

Cash flows from operations — Cash flows from day-to-day, income-producing activities of the firm.

Miscellaneous cash flows — Cash flows incidental to the operations or life cycle of the firm that cannot appropriately be placed in any of the other three categories. Examples include: gifts or inheritances received by the firm, gifts given by the firm, mysterious disappearances of cash held by the firm, etc.

Projected cash flow statement — A projection for a specified future period of expected cash amounts moving through each account and each of the principal categories of revenues and expenses. This projection usually is prepared as a way of predicting the timing and amount of needed borrowing and to demonstrate debt repayment capacity.

Statement of cash flows — A financial statement listing cash amounts moving through each account and principal categories of revenues and expenses during an accounting period and/or during shorter periods (weeks, months, quarters, etc.) within the accounting period. A statement of cash flows generally is intended to answer these questions:

- — In each period, what amount of cash was generated by the firm?
- — In each period, from what sources and in what amounts was cash received?
- — In each period, for what purposes and in what amounts was cash expended?
- — At what times during the accounting period, if any, did the business have cash surpluses?
- — At what times, if any, did the business have cash shortfalls?
- — During the accounting period, at what times and in what amounts were borrowed funds used in business operations?
- — In total, how much cash went through each cash flow category during the accounting period?

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