Small Business Financial Fundamentals Guide:

Guide to Financial Terms

BUSINESSLINK

Accounts Payable

Accounts payable (AP) are bills to be paid as part of the normal course of business. This is a standard accounting term. It is one of the most common liabilities, which normally appears in the balance sheet listing of liabilities. Businesses receive goods or services from a vendor, receive an invoice, and until that invoice is paid the amount is recorded as part of "accounts payable."

Accounts Receivable

Accounts receivable (AR) are debts owed to your company, usually from sales on credit. Accounts receivable is a business asset. It is the sum of the money owed to you by customers who haven't paid.

The standard procedure in business-to-business sales is that when goods or services are delivered, they come with an invoice, which is to be paid later. Business customers expect to be invoiced and to pay later. The money involved goes onto the seller's books as accounts receivable, and onto the buyer's books as accounts payable.

Accrual-Based Accounting

Accrual-based accounting is standard business accounting, which assumes there will be accounts payable (bills to be paid as part of the normal course of business) and/or sales on credit (sales made on account; shipments against invoices to be paid later), as opposed to cash basis only.

For example, most businesses have regular bills such as rent, utilities, and often inventory purchases which are not paid for at the exact moment of purchase but are invoiced. Most businesses will also not be able to collect on all their sales immediately in cash but must bill the purchaser or wait for payment on at least some percentage of their sales (the exact percentage varies by industry).

Accumulated Depreciation

Total accumulated depreciation reduces the formal accounting value (called book value) of assets. Each month's accumulated balance is the same as last month's balance plus this month's depreciation.

Acid Test

An acid test is a business's short-term assets minus accounts receivable and inventory, divided by short-term liabilities.

$$\text{Short-term Assets} - \frac{(\text{Accounts Receivable} + \text{Inventory})}{\text{Short-term Liabilities}}$$

This is a test of a company's ability to meet its immediate cash requirements. It is one of the more common business ratios used by financial analysts.

Acquisition Costs

Acquisition costs are the incremental costs involved in obtaining a new customer.

Balance Sheet

The balance sheet is one of three essential parts that form the bedrock of a company's financial statements: cash flow, balance sheet, and income statement. The balance sheet is a snapshot of your company's assets, liabilities, and owner's equity at a specific point in time. It shows what a company owns (assets), what it owes (liabilities), and how much owners and shareholders have invested (equity). A balance sheet must always balance:

Assets = Liabilities + Equity

Breakeven Analysis

A breakeven analysis is used to assess expected profitability of a company or a single product. It helps you decide at what sales level revenues and expenditures are equal.

Breakeven is usually expressed in terms of the number of units you will need to sell or how much revenue you will need to generate.

The breakeven analysis uses three assumptions to figure out a breakeven point: fixed costs, variable costs, and unit price. Fixed costs and variable costs are both defined in this glossary, and unit price is the average revenue per unit of sales.

The formula for breakeven point in sales amount is:

BEP = Fixed Costs / (Price per Unit - Variable Costs)

The breakeven analysis is often confused with payback period (also in this glossary), because many people interpret breaking even as paying back the initial investment. However, this is not what the breakeven analysis does. Despite the common and more general use of the term “breakeven,” the financial analysis has an exact definition as explained above.

One important disadvantage of the breakeven analysis is that it requires estimating a single per-unit variable cost, and a single per-unit price or revenue, for the entire business. It is a hard concept to estimate in a normal business that has a variety of products/ services to sell.

Another problem that comes up with breakeven is its preference for talking about sales and variable cost of sales in units. Many businesses, especially service businesses, don’t think of sales in units, but rather as sales in money. In those cases, the breakeven analysis should think of the dollar as the unit, and state variable costs per unit as variable costs per dollar of sales.

Learn to calculate your Breakeven Point using our **Breakeven Analysis** guide.

Burden Rate

Burden rate refers to personnel burden, the sum of employer costs over and above salaries (including employer taxes, benefits, and so on).

Capital Assets

Capital assets are long-term assets, also known as fixed assets. These terms are inter-changeable. Assets are generally divided into short-term and long-term assets, the distinction depending on how long they last.

Usually the difference between short-term and long-term is a matter of accounting and financial policy. Five years is probably the most frequent division point, meaning that assets that depreciate over more than five years are long-term assets. Ten years and three years are also common.

Capital Expenditure

All the spending on capital assets (also called plant and equipment, or fixed assets, or long-term assets).

Capital Input

Capital input can also be referred to as investment, or new investment. It is new money being invested in the business, not as loans or repayment of loans, but as money invested in ownership.

This is also money at risk. It will grow in value if the business prospers and decline in value if the business declines. This is closely related to the concept of paid-in capital, on the balance sheet table. Paid-in capital is the amount of money invested in the business as money, or cheques written by investors. Paid-in capital increases only when there is new investment. It is different from retained earnings.

Cash

Cash normally means bills and coins, as in paying in cash. However, the term is used in a business plan to represent the bank balance or chequing account balance.

Cash Basis

Cash basis means an accounting system that doesn't use the standard accrual accounting. It records only cash receipts and cash spending, without assuming sales on credit (sales made on account; shipments against invoices to be paid later) or accounts payable (bills to be paid as part of the normal course of business).

Cash Flow

Cash is the lifeblood of every business and running out of it is the number one reason that small businesses fail. Even if you are making plenty of sales, if you don't have enough cash in the bank, your business won't be able to pay its bills and stay open. That's why it's so important for businesses to understand the basics of cash flow and cash flow forecasting.

Cash flow measures how much money is moving into and out of your business during a specific period. Businesses bring in money through sales, returns on investments, and from loans and investments—that's cash flowing into the business.

Businesses spend money on supplies and services, as well as utilities, taxes, loan payments, and other bills—that's cash flowing out.

How to calculate cash flow

The simplest formula for calculating cash flow is:

Cash Received - Cash Spent = Net Cash Flow

If your net cash flow number is positive, your business is cash flow positive and accumulating cash in the bank.

If your net cash flow number is negative, your business is cash flow negative, and you are finishing the month with less cash than you started with.

What's the difference between Cash and Profit?

Believe it or not, it's possible for your business to be profitable but still run out of cash. That may not be intuitive at first, but it's because cash and profits are very different things. Here's why: Profits can include sales that you've made but haven't been paid for yet.

Cash, on the other hand, is the amount of money you have in your bank account right now. It represents the liquidity of your business and basically, if you can't use it right now to pay your bills, it's not cash.

For example, if you're making a lot of sales but you invoice your customers and they pay you "net 30," or within 30 days of receiving the invoice, you could have lots of revenue on paper but not a lot of cash in your bank account because your customers haven't paid you yet. Those sales will only show up on your income statement.

If the money your customers owe you hasn't made it into your bank account, it won't appear on your cash flow statement yet. It isn't available to your business at this point. It's still in your customers' hands, even though you've invoiced them for it. You keep track of the money your customers owe you in accounts receivable.

Meanwhile, you can only pay your bills with real cash in your bank account. Without that cash in hand, it's going to be tough to fulfill orders, meet payroll, and pay your rent. That's why keeping track of cash flow is so important. To keep your business afloat, you need to have a good sense of what comes in and what goes out of your business on a monthly basis and do everything you can to remain cash flow positive.

Cash Flow Budget

A cash flow budget is a budget that provides an overview of cash inflows and outflows during a specified period. This is often called the cash flow, or the cash budget. Just as cash flow is one of the most critical elements of business, the cash flow projection or table is one of the most critical elements of a business plan.

Cash Flow Statement

The cash flow statement is one of the three main financial statements (along with the income statement and balance sheet) that shows the financial position and health of a business.

The cash flow statement shows actual cash inflows and outflows of a business over a specified period, usually a month or a quarter. The statement then compares cash received to cash spending to determine if a business is cash flow negative or positive. The cash flow statement also often shows how much cash a business has on hand at the end of a given period.

A cash flow positive business is receiving more cash than it is spending. Likewise, a cash flow negative business is spending more cash than it is receiving.

There are two different types of cash flow statements that a business may produce: An indirect cash flow statement and a direct cash flow statement.

Indirect cash flow statement

The indirect method starts with net income from the profit and loss statement and then makes additions and subtractions from that number to arrive at cash flow.

The indirect cash flow statement is more popular because it can be easily created from reports produced by accounting software. That said, it can be more difficult to use for cash flow forecasting.

Direct cash flow statement

The direct method simply totals up cash received and cash spent, and then compares the two numbers to arrive at a cash flow number.

Cash Sales

Cash sales are sales made in cash, or with credit cards, or by cheque. The opposite of sales on credit (sales made on account; shipments against invoices to be paid later).

Cash Spending

Cash spending is money a business spends when it pays obligations immediately instead of letting them wait for a few days first.

Commission

In business, a commission is the compensation paid to the person or entity based on the sale of a product; commonly calculated on a percentage basis.

Compound Average Growth Rate (CAGR)

Compound average growth rate (CAGR) is the rate of return that would be required for an investment to grow from its beginning balance to its ending balance if you reinvest profits every year. The standard formula for compound average growth rate is:

CAGR = (Ending Balance / Beginning Balance) ^ (1 / periods) – 1

Or

$$CAGR = \left(\frac{\text{Ending Balance}}{\text{Beginning Balance}} \right)^{1/n} - 1$$

“n” being the number of years you’d like to examine.

Contribution

Contribution can have different meanings in different contexts. When contribution is applied to a product or product line, it means the difference between total sales revenue and total variable costs. On a per-unit basis, it is the difference between unit selling price and unit variable cost. It may be expressed in percentage terms (contribution margin) or dollar terms (contribution per unit).

Contribution Margin

Contribution is also frequently expressed as contribution margin for a whole company or across a group or product line, in which case it can be taken as gross margin less sales and marketing expenses. **Learn more** abut how the contribution margin can be used as part of your breakeven analysis.

Cost of Goods Sold (COGS)

The cost of goods sold is traditionally the costs of materials and production of the goods a business sells.

For a manufacturing company this is materials, labor, and factory overhead. For a retail shop it would be what it pays to buy the goods that it sells to its customers.

For service businesses, that don't sell goods, the same concept is normally called "cost of sales," which shouldn't be confused with "sales and marketing expenses." The cost of sales in this case is directly analogous to cost of goods sold. For a consulting company, for example, the cost of sales would be the compensation paid to the consultants plus costs of research, photocopying, and production of reports and presentations.

Cost of Sales

Cost of sales refers to the costs associated with producing the sales.

This term is commonly used interchangeably with "cost of goods sold," particularly when it is for a manufacturing, retail, distribution, or other product-based company. In these cases, it is traditionally the costs of materials and production of the goods a business sells.

Current Assets

Current assets are the same as short-term assets.

Current Debt

Current debt refers to short-term debt and short-term liabilities.

Current Liabilities

Current liabilities refer to short-term debt and short-term liabilities.

Debt and Equity

Debt and equity are the sum of liabilities and capital. This should always be equal to total assets.

Depreciation

Depreciation is an accounting and tax concept used to estimate the loss of value of assets over time. For example, cars depreciate with use.

Direct Cost of Sales

Direct cost of sales is a shortcut for cost of goods sold. Traditionally, the costs of materials and production of the goods a business sells, or the costs of fulfilling a service for a service business.

Dividends

Dividends refers to money distributed to the owners of a business as profits.

Earnings

Also called income or profits, earnings are the famous "bottom line": sales less costs of sales and expenses.

Earnings Before Interest and Taxes (EBIT)

EBIT refers to earnings before interest and taxes.

Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)

EBITDA, or earnings before interest, taxes, depreciation, and amortization, is a measure of a company's overall financial performance and is used as an alternative to net income in some circumstances. EBITDA, however, can be misleading because it strips out the cost of capital investments like property, plant, and equipment.

This metric also excludes expenses associated with debt by adding back interest and taxes to earnings. Nonetheless, it is a more precise measure of corporate performance since it is able to show earnings before the influence of accounting and financial deductions.

Simply put, EBITDA is a measure of profitability.

Effective Tax Rate

The effective tax rate is a comparison of the final tax payments compared to actual profits. Usually, the effective tax rate is less than the nominal tax rate because of deductions, credits, and so on.

Equity Financing

Equity financing refers to the sales of some portion of ownership in a venture to gain additional capital for startup and growth.

Expense

For the purposes of business accounting, expenses are deductible against taxable income. Common expenses are rent, salaries, advertising, travel, and so on.

An income statement tracks the income and expenses of a company over a certain period to provide an image of its profitability. Income statements typically categorize expenses into six groups: cost of goods sold; selling, general, and administrative costs; depreciation and amortization; other operating expenses; interest expenses; and income taxes. All these expenses can be considered operating expenses, but when determining operating income using an income statement, interest expenses and income taxes are excluded.

It's often hard to tell the difference between an asset and an expense. The best example of an asset versus an expense is a mortgage versus rent. The amount of cash you spend on your mortgage or your rent can be the same. But the impact on your **net worth**—the total amount of what you own minus what you owe—can be significant.

With a mortgage, your ownership value in the property grows each month with each payment you make. That's because a portion of your payment is principal, and that reduces your loan, which increases your ownership. The rest of the payment is interest, which is an expense. With a mortgage, you can sell your ownership in the property and get cash or another asset in a trade in the future. When you pay rent, however, there's nothing left at the end of the month; there's no accumulating value.

Fiscal Year

The fiscal year is a standard accounting practice that allows the accounting year to begin in any month. Fiscal years are numbered according to the year in which they end. For example, a fiscal year ending in February of 2018 is Fiscal 2018, even though most of the year takes place in 2017.

Fixed Cost

Fixed costs are costs that take time to wind down: usually rent, overhead, and some salaries. Technically, fixed costs are those that the business would continue to pay even if it went bankrupt.

In practice, fixed costs are usually considered the running costs. These are static expenses that do not fluctuate with output volume and become progressively smaller per unit of output as volume increases.

Fixed costs are an important assumption for developing a breakeven analysis. The standard breakeven formula estimates a breakeven point of sales based on per-unit price or revenue, per-unit variable costs, and fixed costs.

Fixed Liabilities

Fixed liabilities are debts—money that must be paid. Usually, debt on terms of longer than five years are fixed liabilities. They can also be called long-term liabilities.

Floating Liabilities

Floating liabilities are debts—money that must be paid. Floating liabilities, in contrast to fixed liabilities, are secured by assets with a constantly changing value, such as a company's accounts receivable (debtors). These are usually short-term loans.

Gross Margin

Gross margin is the difference between total sales revenue and total cost of goods sold (also called total cost of sales). This can also be expressed on a per unit basis, as the difference between unit selling price and unit cost of goods sold. Gross margin can be expressed in dollar or percentage terms.

Gross Margin Percent

The gross margin percent is the gross margin divided by sales, displayed as a percentage. Acceptable levels depend on the nature of the business.

Income Statement

Also called profit and loss statement, an income statement is a financial statement that shows sales, cost of sales, gross margin, operating expenses, and profits or losses. Gross margin is sales less cost of sales, and profit (or loss) is gross margin less operating expenses and taxes. The result is profit if it's positive, loss if it's negative.

Interest Expense

Interest expense is interest that is paid on debts, and interest expense is deducted from profits as an expense. Interest expense is either long-term or short-term interest.

Liabilities

Liabilities are debts, or money that must be paid. Usually debt on terms of less than five years is called short-term liabilities, and debt for longer than five years is called long-term liabilities.

Long-Term Assets

Long-term assets are assets like factory and equipment that are depreciated over terms of more than five years, and are likely to last that long, too.

Long-Term Interest Rate

Long-term interest rate is the interest rate charged on long-term debt.

Long-Term Liabilities

Long-term liabilities are the same as long-term loans. Most companies call a debt long-term when it is on terms of five years or more. They can also be called fixed liabilities.

Loss

Loss is an accounting concept, the exact opposite of profit, normally the bottom line of the income statement. Start with sales, subtract all costs of sales and all expenses, and that produces profit before tax. Subtract tax to get net profit. If the result is negative, then instead of profit it is called loss.

Net Cash Flow

Net cash flow is the projected change in cash position, an increase or decrease in cash balance.

Net Present Value (NPV)

Net present value is a method of discounting future streams of income using an expected rate of return to evaluate the current value of expected earnings. It calculates future value in today's dollars. NPV may be used to determine the current value of a business being offered for sale or capitalized.

Net Profit

Net profit is the operating income less taxes and interest. The same as earnings, or net income.

Net Worth

Net worth is the value of a company's total assets minus its total liabilities.

On-Costs

On-costs are labor costs in addition to salaries and wages; that is, payroll tax, workers' compensation and other liability insurance, the cost of subsidized services to employees, training costs, and so on.

Operating Expenses

Operating expenses are expenses incurred in conducting normal business operations. Operating expenses may include wages, salaries, administrative and research and development costs, but excludes interest, depreciation, and taxes.

Opportunity Cost

Opportunity cost refers to the resource use options that are given up because of pursuing one activity among several possibilities. It reflects potential benefits foregone as a result of choosing an alternative course of action.

Other Short-Term Liabilities

Other short-term liabilities are short-term debts that don't cause interest expenses. For example, they might be loans from founders or accrued taxes (taxes owed, already incurred, but not yet paid).

Paid-In Capital

Paid-in capital is real money paid into the company as investments. This is not to be confused with par value of stock, or market value of stock. This is actual money to the company as equity investments by owners.

Payables

Payables is short for accounts payable—bills to be paid as part of the normal course of business. This is a standard accounting term and one of the most common liabilities, which normally appears in the balance sheet listing of liabilities.

Businesses receive goods or services from a supplier, receive an invoice, and until that invoice is paid the amount is recorded as part of "accounts payable."

Payroll

Payroll refers to wages, salaries, or employee compensation.

Payroll Burden

Payroll burden includes payroll taxes and benefits. It is calculated using a percentage assumption that is applied to payroll.

For example, if payroll is $1,000 and the burden rate is 10 percent, the burden is an extra $100. Acceptable payroll burden rates vary by market, by industry, and by company.

Pro Forma Income Statement

A pro forma income statement is a projected income statement. Pro forma in this context means projected. An income statement is the same as a profit and loss statement, a financial statement that shows sales, cost of sales, gross margin, operating expenses, and profits.

Profit

Profit is an accounting concept, normally the bottom line of the income statement. Start with sales, subtract all costs of sales and all expenses, and that produces profit before tax. Subtract tax to get net profit.

Profit Before Interest and Taxes

Profit before interest and taxes is also called EBIT, for Earnings Before Interest and Taxes. It is gross margin minus operating expenses.

Profit or Loss Statement

A profit or loss statement is the same as an income statement, which is a financial statement that shows sales, cost of sales, gross margin, operating expenses, and profits or losses. Gross margin is sales less cost of sales, and profit (or loss) is gross margin less operating expenses and taxes. The result is profit if it's positive, loss if it's negative.

Questionable Costs

Questionable costs are costs that may be considered as variable or as fixed costs, depending on the specifics of the situation. For example, management salaries can be considered as fixed costs for a manufacturing company as these employees are paid whether the company is manufacturing at full production capacity or not. Employee wages for workers on the production floor would be considered variable costs as these employees may be laid off during slower production times and their wages decreased.

Receivables

Short for accounts receivables, this refers to debts owed to your company, usually from sales on credit. Accounts receivable is a business asset, the sum of the money owed to you by customers who haven't paid.

The standard procedure in business-to-business sales is that when goods or services are delivered, they come with an invoice, which is to be paid later. Business customers expect to be invoiced and to pay later. The money involved goes onto the seller's books as accounts receivable, and onto the buyer's books as accounts payable.

Receivables Turnover

Receivables turnover refers to sales on credit for an accounting period divided by the average accounts receivable balance.

Relevant Cost

Relevant cost refers to expenditures that are expected to occur in the future as a result of some marketing action and differ among other potential marketing alternatives.

Retained Earnings

Retained earnings are earnings that have been reinvested into the company, not paid out as dividends to the owners. When retained earnings are negative, the company has accumulated losses.

Return on Assets

Return on assets is your net profits divided by total assets. It is a measure of profitability.

Return on Investment (ROI)

Return on investment, or ROI, is your net profits divided by net worth or total equity. It is a measure of profitability. Investors and shareholders use this to measure your efficiency against others in your industry. Learn more **here**.

Return on Sales

Return on sales is net profits divided by sales. It is a measure of profitability.

Seed Capital

Seed capital is investment contributed at a very early stage of a new venture, usually in relatively small amounts. It comes even before what they call "first round" venture capital.

Learn more about seed capital at **Investopedia**.

Short-Term

Short-term is normally used to distinguish between short-term and long-term, when referring to assets or liabilities. Definitions vary because different companies and accountants handle this in different ways.

Accounts payable is always a short-term liability, and cash, accounts receivable and inventory are always short-term assets. Most companies call any debt of less than one-year term short-term debt. Assets that depreciate over more than five years (e.g., plant and equipment) are usually long-term assets.

Short-Term Assets

Short-term assets are cash, securities, bank accounts, accounts receivable, inventory, business equipment, assets that last less than one year or are depreciated over terms of less than one year. Also called current assets.

Short-Term Liabilities

Short-term liabilities are debts with terms of five years or less. These are also called current liabilities, short-term loans, or short-term (current) debts. These may also include short-term debts that don't cause interest expenses. For example, they might be loans from founders or accrued taxes (taxes owed, already incurred, but not yet paid).

Short-Term Notes

Short-term notes are the same as short-term loans. These are debts with terms of five years or less.

Sunk Cost

Sunk cost refers to past expenditures for a given activity that are typically irrelevant in whole or in part to future decisions. The “sunk cost fallacy” is an attempt to recoup spent dollars by spending still more dollars in the future.

Surplus or Deficit

Surplus or deficit is a term used by nonprofits. It’s also called profit and loss statement or an income statement in for-profit plans.

It is a financial statement that shows funding, cost of funding, gross surplus, operating expenses, and surplus or deficit. Gross surplus is funding less cost of funding, and surplus (or deficit) is gross surplus less operating expenses and taxes. The result is surplus if it is positive, deficit if it is negative.

Tax Rate Percent

Tax rate percent is an assumed percentage applied against pre-tax income to determine taxes.

Unit Variable Cost

Unit variable cost is the specific labor and materials associated with a single unit of goods sold. Does not include general overhead.

Unpaid Expenses

Unpaid expenses mean money owed to vendors for expenses incurred, but not yet paid. In bookkeeping and accounting, this is called accounts payable. A simple example would be the advertising expense from advertising that has already run but not yet been paid for by the advertiser.

Variable Cost

Variable costs are costs that fluctuate in direct proportion to the volume of units produced. The best and most obvious example are physical costs of goods sold, direct costs, such as materials, products purchased for resale, production costs and overhead, etc.

The concept of variable cost is an important component of risk in a company. Generally variable costs are less risky than fixed costs, because variable costs are not incurred unless there are sales and production. See also breakeven analysis, fixed costs, and contribution.

Venture Capital

Venture capital is capital needed in the earliest stages of the venture's creation before the product or service is available to be sold.

Working Capital

Working capital is the accessible resources needed to support the day-to-day operations of an organization.

Working capital is commonly in the form of cash and current (short-term) assets, including accounts receivable, prepaid expenses minus accounts payable for goods and services, and current unpaid income taxes.