

# Accounting Terms

**Amortization:** Amortization is a method of spreading an intangible asset's cost over the course of its useful life. Intangible assets are non-physical assets that are essential to a company, such as a trademark, patent, copyright, or franchise agreement.

**Asset:** Assets are items you own that can provide future benefit to your business, such as cash, inventory, real estate, office equipment, or accounts receivable, which are payments due to a company by its customers. There are different types of assets, including:

- ▶ **Current Assets:** Can be converted to cash within a year
- ▶ **Fixed Assets:** Can't immediately be turned into cash, but are tangible items a company owns and uses to generate long-term income

**Balance Sheet:** A balance sheet is a financial statement that communicates an organization's worth, or "book value." The balance sheet includes a tally of the organization's assets, liabilities, and shareholders' equity for a given reporting period.

- ▶ **The Balance Sheet Equation:** Balance sheets are arranged according to the equation:  
**Assets = Liabilities + Owners' Equity**

**Cash Flow:** Cash flow refers to the net balance of cash moving in and out of a business at a specific point in time. Cash flow is commonly broken into three categories, including:

- ▶ **Operating Cash Flow:** The net cash generated from normal business operations

- ▶ **Investing Cash Flow:** The net cash generated from investing activities, such as securities investments and the purchase or sale of assets

- ▶ **Financing Cash Flow:** The net cash generated when financing a business, including debt payments, shareholders' equity, and dividend payments

**Cash Flow Statement:** A cash flow statement is a financial statement prepared to provide a detailed analysis of what happened to a company's cash during a given period. This document shows how the business generated and spent its cash by including an overview of cash flows from operating, investing, and financing activities during the reporting period.

**Depreciation:** Depreciation represents the decrease in an asset's value. It's a term commonly used in accounting and shows how much of an asset's value a business has used over a period of time.

**EBITDA:** An acronym standing for "Earnings Before Interest, Taxes, Depreciation, and Amortization," EBITDA is a commonly used measure of a company's ability to generate cash flow. To get EBITDA, add net profit, interest, taxes, depreciation, and amortization together.

**Equity:** Equity is the residual assets that belong to the owners of the business by adding up all the resources of the business (assets) and subtracting all the claims that third parties (such as lenders and suppliers) have against those assets.

**Expense:** An expense is a cost associated with providing goods or services to customers.

**Income Statement:** An income statement is a financial statement that summarizes a business's income and expenses during a given period. It's also sometimes referred to as a **profit and loss (P&L) statement**.

**Liability:** The opposite of assets, liabilities are what you owe other parties, such as bank debt, wages, and money due to suppliers—also known as **accounts payable**. There are different types of liabilities, including:

- ▶ **Current Liabilities:** Also known as short-term liabilities, these are due within a year.
- ▶ **Long-Term Liabilities:** These are financial obligations that can be paid off over a longer period of time.

**Liquidity:** Liquidity describes how quickly your assets can be converted into cash. As a result, cash is the most liquid asset. The least liquid assets are items like real estate or land, because they can take weeks or months to sell.

**Net Worth:** You can calculate net worth by subtracting what you owe—your **liabilities**—from what you own—your **assets**. The remaining number can help you determine your overall financial health.

**Profit Margin:** Profit margin is a measure of profitability calculated by dividing net income by revenue or net profit by sales. Companies often analyze two types of profit margins:

- ▶ **Gross Profit Margin:** Applies to a specific product or line item rather than an entire business
- ▶ **Net Profit Margin:** Represents the profitability of an entire company

**Revenue:** Revenue is the money a business brings in from its customers for providing goods or services related to its normal operations.

**Working Capital:** Also known as **net working capital**, this is the difference between a company's current assets and current liabilities. Working capital—the money available for daily operations—can help determine an organization's operational efficiency and short-term financial health.

# Investment Terms

**Alternative Investments:** Alternative investments, also called **alternative assets**, are asset classes that aren't stocks, bonds, or cash. They differ from traditional investments because they aren't easily sold or converted into cash.

**Annuity:** An annuity is an investment type in which the purchaser obtains the right to receive a fixed amount each year for a lifetime or for a certain period.

**Asset Allocation:** Asset allocation refers to how you spread your money across different investment types—also called **asset classes**.

**Asset Classes:** Asset classes are different types of investments grouped by qualities, laws, and regulations. These include:

- ▶ **Bonds:** Bonds represent a form of borrowing. When you buy a bond—typically from the government or a corporation—you're essentially lending them money. You receive periodic interest payments and get back the loaned amount at the time of the bond's maturity—the defined term at which the bond can be redeemed.
- ▶ **Stocks:** A stock is a share of ownership in a public or private company. When you buy stock in a company, you become a shareholder and can receive dividends—the company's profits—if and when they're distributed.
- ▶ **Cash and Cash Equivalents:** This refers to any asset in the form of cash, or one that can be converted to cash easily if necessary.

**Capital Gain:** A capital gain is an increase in the value of an asset or investment above the price you initially paid for it. If you sell the asset for less than the original purchase price, that would be considered a **capital loss**.

**Capital Market:** This is a market where buyers and sellers engage in the trade of financial assets, including stocks and bonds. Capital markets feature several participants, including:

- ▶ **Companies:** Firms that sell stocks and bonds to investors
- ▶ **Institutional Investors:** Investors who purchase stocks and bonds on behalf of a large capital base
- ▶ **Mutual Funds:** A mutual fund is an institutional investor that manages the investments of thousands of individuals.
- ▶ **Hedge Funds:** A hedge fund is another type of institutional investor, which controls risk through **hedging**—a process of buying one stock and shorting a similar stock to make profit from the difference in their relative performance.

**Compound Interest:** This refers to “interest on interest.” When you're investing or saving, compound interest is earned on the amount you deposited, plus any interest you've accumulated over time. While it can grow your savings, it can also increase your debt; compound interest is charged on the initial amount you were loaned, as well as the expenses added to your outstanding balance over time.

**Distress Investing:** Distress investing, also called **distressed debt investing**, is an investment strategy that targets financially distressed companies, with the intent of controlling the restructuring process or being paid off not to intervene with the restructuring process.

**Diversification:** Diversification is the process in which investors diversify their holdings by investing in several companies across different industries to reduce risk from pricing volatility, rather than owning stock in a single company.

**Dividend:** A dividend is cash paid to shareholders on a per-share basis to distribute a portion of the free cash generated by a business.

**Fundamental Investing:** Fundamental investing is an investment strategy based on selecting overpriced or underpriced stocks based on deep analysis of the value of the underlying company.

**Impact Investing:** Impact investors intentionally invest in innovative solutions that can potentially create environmental or social impact in a measurable way (for example, low-carbon cement to help combat climate change). Some are willing to accept lower returns in exchange for greater impact.

**Interest Rate:** Interest rate is the percentage rate paid over a period of time for debt owed by a company (in the form of loans, bonds issued, or notes) and for assets in cash equivalent accounts (for example, savings or treasury bills).

**Organic Investments:** Organic investments are investments within the company, often in its expansion.

**Quantitative Investing:** Quantitative investing is a hedge fund strategy that uses computing power to automatically invest based on algorithms. Benefits can include speed and scalability.

**Security:** A security is a negotiable and tradable financial instrument that holds some type of monetary value. Three types of securities are:

- ▶ **Equity:** Equity security represents ownership interest held by shareholders in an entity, for example, capital stock.
- ▶ **Debt:** Debt security is borrowed money that must be repaid according to agreed-upon terms. Examples include government or corporate bonds and certificates of deposit.
- ▶ **Hybrid:** Combining some characteristics from equity and debt securities, hybrid securities include equity warrants, convertible bonds, and preference shares.

**Sustainable Investing:** Sustainable investing refers to a range of practices in which investors aim to achieve financial returns while promoting long-term environmental or social value.

**Valuation:** Valuation is the process of determining the current worth of an asset, company, or liability. If valuing a business, regularly repeating the process can be helpful so you can be ready if ever faced with an opportunity to merge or sell your company, or are trying to seek funding from outside investors.

# Financial Analysis Formulas

**Current Ratio:** The current ratio is a measure of a business's ability to pay its short-term obligations.

It's calculated as  $\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$ .

**Debt to Equity Ratio:** Debt to equity ratio is a common measure of financial leverage. A high debt to equity ratio means that a company uses debt to finance its growth.

It's calculated as  $\text{Debt to Equity Ratio} = \text{Total Liabilities} / \text{Total Equity}$ .

**Gross Profit:** Gross profit is the amount by which revenue exceeds the cost of goods sold (or cost of sales).

It's calculated as  $\text{Gross Profit} = \text{Net Revenue} - \text{Cost of Goods Sold}$ .

**Gross Margin:** Gross margin is used as a measure of profitability. Calculating it yields the percentage of revenue left to cover other expenses after the cost of goods sold is subtracted.

It's calculated as  $\text{Gross Margin} = \text{Gross Profit} / \text{Revenue}$  and expressed as a percentage.

**Net Income:** Net income (or net profit) is a company's total earnings (or profit).

It's calculated as  $\text{Net Income} = \text{Total Revenue} - \text{Total Expenses}$ .

**Net Margin:** Net margin (or net profit margin) is a company's ratio of net profit to revenue.

It's calculated as  $\text{Net Margin} = \text{Net Profit} / \text{Revenue}$  and expressed as a percentage.

**Quick Ratio:** The quick ratio is a measure of a business's ability to pay its short-term obligations. While the current ratio measures the same thing, the quick ratio is a more stringent test.

It's calculated as  $\text{Quick Ratio} = (\text{Current Assets} - \text{Current Inventory}) / \text{Current Liabilities}$ .

**Return on Investment (ROI):** Return on investment is used to determine the expected return of a project or activity compared to the cost of the investment—typically shown as a percentage. This measure is often used to evaluate whether a project is worthwhile for a business to pursue.

It's calculated as  $\text{ROI} = [(\text{Income} - \text{Cost}) / \text{Cost}] \times 100$ .

**Working Capital:** Also known as net working capital, this is the difference between a company's current assets and current liabilities. Working capital—the money available for daily operations—can help determine an organization's operational efficiency and short-term financial health.

It's calculated as  $\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$ .