



# Financial Terms Glossary

## Business financial terms and ratios definitions

These financial terms definitions are for the most commonly used UK financial terms and ratios.

They are based on UK Company Balance Sheet, Profit and Loss Account, and Cash-flow Statement conventions.

Certain financial terms often mean different things to different organisations depending on their own particular accounting policies. So as a general rule for all non-financial business people, if in doubt, ask for an explanation from the person or organisation responsible for producing the figures and using the terms - you may be the only one to ask, but you certainly will not be the only one wondering what it all means.

Don't be intimidated by financial terminology or confusing figures and methodology. Always ask for clarification, and you will find that most financial managers and accountants are very happy to explain.

### Acid test

A stern measure of a company's ability to pay its short term debts, in that stock is excluded from asset value. (liquid assets/current liabilities)

### Assets

Anything owned by the company having a monetary value; e.g. 'fixed' assets like buildings, plant and machinery and 'current' assets, such as stock, debtors and cash.

### Asset turnover

Measure of operational efficiency - shows how much revenue is produced per £ of assets available to the business. (sales revenue/total assets less current liabilities)

### Balance sheet

The Balance Sheet is one of the three essential measurement reports for the performance and health of a school along with the Profit and Loss Account and the Cash-flow Statement. The Balance Sheet is a 'snapshot' in time of who owns what, and what assets and debts represent the value of the company. (It can only ever be a snapshot because the picture is always changing.)

The Balance Sheet is where to look for information about short-term and long-term debts, gearing (the ratio of debt to equity), reserves, stock values, capital assets and cash on hand.

The term 'balance sheet' is derived from the simple purpose of detailing where the money came from, and where it is now. The balance sheet equation is fundamentally: (where the money came from) Capital + Liabilities = Assets (where the money is now).

Hence the term 'double entry' - for every change on one side of the balance sheet, so there must be a corresponding change on the other side - it must always balance.

The Balance Sheet does not show how much profit the company is making (the P&L does this), although previous years' retained profits will add to the company's reserves, which are shown in the balance sheet.

## **Budget**

In a financial planning context the word 'budget' (as a noun) strictly speaking means an amount of money that is planned to spend on a particular activity or resource, usually over a trading year, although budgets apply to shorter and longer periods.

An overall organisational plan therefore contains the budgets within it for all the different departments and costs held by them. The verb 'to budget' means to calculate and set a budget, although in a looser context it also means to be careful with money and find reductions (effectively by setting a lower budgeted level of expenditure).

The word budget is also more loosely used by many people to mean the whole plan. In which context a budget means the same as a plan.

A 'forecast' in certain contexts means the same as a budget - either a planned individual activity/resource cost, or a whole business plan. A 'forecast' more commonly means a prediction of performance - costs and/or revenues, or other data such as headcount, % performance, etc., especially when the 'forecast' is made during the trading period, and normally after the plan or 'budget' has been approved.

## **Capital employed**

The value of all resources available to the company, typically comprising share capital, retained profits and reserves, long-term loans and deferred taxation. Viewed from the other side of the balance sheet, capital employed comprises fixed assets, investments and the net investment in working capital (current assets less current liabilities). In other words: the total long-term funds invested in or lent to the business and used by it in carrying out its operations.

## **Cash-flow**

The movement of cash in and out of a business from day-to-day direct trading and other non-trading or indirect effects, such as capital expenditure, tax and dividend payments.

## **Cash-flow statement**

One of the three essential reporting and measurement systems for any company. The cash-flow statement provides a third perspective alongside the Profit and Loss account and Balance Sheet.

The Cash-flow statement shows the movement and availability of cash through and to the business over a given period, certainly for a trading year, and often also monthly and cumulatively.

The availability of cash in a company that is necessary to meet payments to suppliers, staff and other creditors is essential for any business to survive, and so the reliable forecasting and reporting of cash movement and availability is crucial.

## **Cost of debt ratio (average cost of debt ratio)**

Despite the different variations used for this term (cost of debt, cost of debt ratio, average cost of debt ratio, etc) the term normally and simply refers to the interest expense over a given period as a percentage of the average outstanding debt over the same period, i.e. cost of interest divided by average outstanding debt.

## **Cost of goods sold (COGS)**

The directly attributable costs of products or services sold, (usually materials, labour, and direct production costs). Sales less COGS = gross profit. Effectively the same as cost of sales (COS) see below for fuller explanation.

## **Cost of sales (COS)**

Commonly arrived at via the formula: opening stock + stock purchased - closing stock.

Cost of sales is the value, at cost, of the goods or services sold during the period in question, usually the financial year, as shown in a Profit and Loss Account (P&L).

In all accounts, particularly the P&L (trading account) it's important that costs are attributed reliably to the relevant revenues, or the report is distorted and potentially meaningless. To use simply the total value of stock purchases during the period in question would not produce the correct and relevant figure, as some product sold was already held in stock before the period began, and some product bought during the period remains unsold at the end of it.

Some stock held before the period often remains unsold at the end of it too. The formula is the most logical way of calculating the value at cost of all goods sold, irrespective of when the stock was purchased. The value of the stock attributable to the sales in the period (cost of sales) is the total of what we started with in stock (opening stock), and what we purchased (stock purchases), minus what stock we have left over at the end of the period (closing stock).

## **Current assets**

Cash and anything that is expected to be converted into cash within twelve months of the balance sheet date.

## **Current ratio**

The relationship between current assets and current liabilities, indicating the liquidity of a business, i.e. its ability to meet its short-term obligations. Also referred to as the Liquidity Ratio.

## **Current liabilities**

Money owed by the business that is generally due for payment within 12 months of balance sheet date. Examples: creditors, bank overdraft, taxation.

## **Depreciation**

The apportionment of cost of a (usually large) capital item over an agreed period, (based on life expectancy or obsolescence), for example, a piece of equipment costing £10k having a life of five years might be depreciated over five years at a cost of £2k per year. (In which case the P&L would show a depreciation cost of £2k per year; the balance sheet would show an asset value of £8k at the end of year one, reducing by £2k per year; and the cash-flow statement would show all £10k being used to pay for it in year one.)

## **Dividend**

A dividend is a payment made per share, to a company's shareholders by a company, based on the profits of the year, but not necessarily all of the profits, arrived at by the directors and voted at the company's annual general meeting. A company can choose to pay a dividend from reserves following a loss-making year, and conversely a company can choose to pay no dividend after a profit-making year, depending on what is believed to be in the best interests of the company. Keeping shareholders happy and committed to their investment is always an issue in

deciding dividend payments. Along with the increase in value of a stock or share, the annual dividend provides the shareholder with a return on the shareholding investment.

### **Earnings before..**

There are several 'Earnings Before..' ratios and acronyms: EBT = Earnings Before Taxes; EBIT = Earnings Before Interest and Taxes; EBIAT = Earnings Before Interest after Taxes; EBITD = Earnings Before Interest, Taxes and Depreciation; and EBITDA = Earnings Before Interest, Taxes, Depreciation, and Amortization. (Earnings = operating and non-operating profits (e.g interest, dividends received from other investments). Depreciation is the non-cash charge to the balance sheet which is made in writing off an asset over a period. Amortisation is the payment of a loan in instalments.

### **Fixed assets**

Assets held for use by the business rather than for sale or conversion into cash, e.g. fixtures and fittings, equipment, buildings.

### **Fixed cost**

A cost which does not vary with changing sales or production volumes, e.g. building lease costs, permanent staff wages, rates, depreciation of capital items.

### **Forecast**

See 'budget' above.

### **Gearing**

The ratio of debt to equity, usually the relationship between long-term borrowings and shareholders' funds.

### **Goodwill**

Any surplus money paid to acquire a company that exceeds its net tangible assets value.

### **Gross profit**

Sales less cost of goods or services sold. Also referred to as gross profit margin, or gross profit, and often abbreviated to simply 'margin'. See also 'net profit'.

### **Letters of credit**

These mechanisms are used by exporters and importers, and usually provided by the importing company's bank to the exporter to safeguard the contractual expectations and particularly financial exposure of the exporter of the goods or services. (Also called 'export letters of credit, and 'import letters of credit'.)

When an exporter agrees to supply a customer in another country, the exporter needs to know that the goods will be paid for.

The common system, which has been in use for many years, is for the customer's bank to issue a 'letter of credit' at the request of the buyer, to the seller. The letter of credit essentially guarantees that the bank will pay the seller's invoice (using the customer's money of course) provided the goods or services are supplied in accordance with the terms stipulated in the letter, which should obviously reflect the agreement between the seller and buyer.

This gives the supplier an assurance that their invoice will be paid, beyond any other assurances or contracts made with the customer. Letters of credit are often complex documents that require careful drafting to protect the interests of buyer and seller. The customer's bank charges a fee to issue a letter of credit, and the customer pays this cost.

The seller should also approve the wording of the buyer's letter of credit, and often should seek professional advice and guarantees to this effect from their own financial services provider.

### **Letters of guarantee**

There are many types of letters of guarantee. These types of letters of guarantee are concerned with providing safeguards to buyers that suppliers will meet their obligations or vice-versa, and are issued by the supplier's or customer's bank depending on which party seeks the guarantee. While a letter of credit essentially guarantees payment to the exporter, a letter of guarantee provides safeguard that other aspects of the supplier's or customer's obligations will be met. The supplier's or customer's bank is effectively giving a direct guarantee on behalf of the supplier or customer that the supplier's or customer's obligations will be met, and in the event of the supplier's or customer's failure to meet obligations to the other party then the bank undertakes the responsibility for those obligations.

Typical obligations covered by letters of guarantee are concerned with:

- Tender Guarantees (Bid Bonds) - whereby the bank assures the buyer that the supplier will not refuse a contract if awarded.
- Performance Guarantee - This guarantees that the goods or services are delivered in accordance with contract terms and timescales.
- Advance Payment Guarantee - This guarantees that any advance payment received by the supplier will be used by the supplier in accordance with the terms of contract between seller and buyer.

There are other types of letters of guarantee, including obligations concerning customs and tax, etc, and as with letters of credit, these are complex documents with extremely serious implications. For this reasons suppliers and customers alike must check and obtain necessary validation of any issued letters of guarantee.

### **Liabilities**

General term for what the business owes. Liabilities are long-term loans of the type used to finance the business and short-term debts or money owing as a result of trading activities to date. Long term liabilities, along with Share Capital and Reserves make up one side of the balance sheet equation showing where the money came from. The other side of the balance sheet will show Current Liabilities along with various Assets, showing where the money is now.

### **Liquidity ratio**

Indicates the company's ability to pay its short term debts, by measuring the relationship between current assets (i.e. those which can be turned into cash) against the short-term debt value. (current assets/current liabilities) Also referred to as the Current Ratio.

### **Net assets (also called total net assets)**

Total assets (fixed and current) less current liabilities and long-term liabilities that have not been capitalised (e.g. short-term loans).

### **Net current assets**

Current Assets less Current Liabilities.

### **Net profit**

Net profit can mean different things so it always needs clarifying. Net strictly means 'after all deductions' (as opposed to just certain deductions used to arrive at a gross profit or margin). Net profit normally refers to profit after deduction of all operating expenses, notably after deduction of fixed costs or fixed overheads. This contrasts with the term 'gross profit' which normally refers to the difference between sales and direct cost of product or service sold (also referred to as gross margin or gross profit margin) and certainly before the deduction of operating costs or overheads. Net profit normally refers to the profit figure before deduction of corporation tax, in which case the term is often extended to 'net profit before tax' or PBT.

### **Opening/closing stock**

See explanation under Cost of Sales.

### **Profit and loss account (P&L)**

One of the three principal business reporting and measuring tools (along with the balance sheet and cash-flow statement). The P&L is essentially a trading account for a period, usually a year, but also can be monthly and cumulative. It shows profit performance, which often has little to do with cash, stocks and assets (which must be viewed from a separate perspective using balance sheet and cash-flow statement). The P&L typically shows sales revenues, cost of sales/cost of goods sold, generally a gross profit margin (sometimes called 'contribution'), fixed overheads and or operating expenses, and then a profit before tax figure (PBT). A fully detailed P&L can be highly complex, but only because of all the weird and wonderful policies and conventions that the company employs. Basically the P&L shows how well the company has performed in its trading activities.

### **Overhead**

An expense that cannot be attributed to any one single part of the company's activities.

### **Reserves**

The accumulated and retained difference between profits and losses year on year since the company's formation.

### **Restricted funds**

These are funds used by an organisation that are restricted or earmarked by a donor for a specific purpose, which can be extremely specific or quite broad, e.g., endowment or pensions investment; research (in the case of donations to a charity or research organisation); or a particular project with agreed terms of reference and outputs such as to meet the criteria or terms of the donation or award or grant. The source of restricted funds can be from government, foundations and trusts, grant-awarding bodies, philanthropic organisations, private donations, bequests from wills, etc. The practical implication is that restricted funds are ring-fenced and must not be used for any other than their designated purpose, which may also entail specific reporting and timescales, with which the organisation using the funds must comply. A glaring example of misuse of restricted funds would be when Maxwell spent Mirror Group pension funds on Mirror Group development.

### **Return on capital employed (ROCE)**

A fundamental financial performance measure. A percentage figure representing profit before interest against the money that is invested in the business. (profit before interest and tax/capital employed x 100)

### **Return on investment**

Another fundamental financial and business performance measure. This term means different things to different people (often depending on perspective and what is actually being judged) so it's important to clarify understanding if interpretation has serious implications.

Many business managers and owners use the term in a general sense as a means of assessing the merit of an investment or business decision. 'Return' generally means profit before tax, but clarify this with the person using the term - profit depends on various circumstances, not least the accounting conventions used in the business. In this sense most CEO's and business owners regard ROI as the ultimate measure of any business or any business proposition, after all it's what most business is aimed at producing - maximum return on investment, otherwise you might as well put your money in a bank savings account. Strictly speaking Return On Investment is defined as:

Profits derived as a proportion of and directly attributable to cost or 'book value' of an asset, liability or activity, net of depreciation.

In simple terms this **the profit made from an investment**. The 'investment' could be the value of a whole business (in which case the value is generally regarded as the company's total assets minus intangible assets, such as goodwill, trademarks, etc and liabilities, such as debt. N.B. A company's book value might be higher or lower than its market value); or the investment could relate to a part of a business, a new product, a new factory, a new piece of plant, or any activity or asset with a cost attached to it.

The main point is that the term seeks to define the profit made from a business investment or business decision. Bear in mind that costs and profits can be ongoing and accumulating for several years, which needs to be taken into account when arriving at the correct figures.

### **Share capital**

The balance sheet nominal value paid into the company by shareholders at the time(s) shares were issued.

### **Shareholders' funds**

A measure of the shareholders' total interest in the company represented by the total share capital plus reserves.

### **Variable cost**

A cost which varies with sales or operational volumes, e.g materials, fuel, commission payments.

### **Working capital**

Current assets less current liabilities, representing the required investment, continually circulating, to finance stock, debtors, and work in progress.

