
Financial analysis glossary

ACCOUNTS PAYABLE

Synonyms: payables, creditors

Amounts owed by an organization to others for goods or services received. Buying from suppliers on credit will generate accounts payable.

ACCOUNTS RECEIVABLE

Synonyms: receivables, debtors

Amounts due to an organization for goods delivered or services rendered. Selling to customers on credit will generate accounts receivable for a business.

ACCOUNTS PAYABLE DAYS RATIO

Accounts payable / COGS x 365. Average number of days a firm takes to pay for items purchased.

ACCOUNTS PAYABLE TURNOVER

Cost of sales / Accounts payable (either the ending balance or average balance). This ratio measures how effective management is in paying its suppliers.

ACCOUNTS RECEIVABLE DAYS RATIO

Accounts receivable / Sales x 365. Average number of days a firm takes to collect payments on goods sold.

ACCOUNTS RECEIVABLE TURNOVER

Sales / Accounts receivable (either the ending balance, or average balance). This ratio measures how effective the company's credit policies are.

ACID TEST

See quick ratio.

ADMINISTRATION COST RATIO

Administration costs / Sales. This margin shows the general overhead cost for each dollar of sales.

AMORTIZATION

The gradual reduction of a financial amount over time.

ASSETS

Resources owned and employed by an organization which confer future economic benefits.

ASSET TURNOVER RATIO

Sales / Total assets. This ratio shows how effective the company is in generating sales from its assets.

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AUDIT

The process of examination and verification of a firm's books of account, transaction records, and other relevant documents including financial models.

AVERAGE BALANCE

$(\text{Opening balance} - \text{Closing balance}) / 2$. This balance can be used to calculate efficiency / turnover ratios instead of using a closing balance.

BALANCE SHEET

The balance sheet is a 'snapshot' of an organization's assets and liabilities on a particular date. The balance sheet shows the sources of funds provided to an organization (called the capital employed and normally either equity or debt) and how those funds have been used by the organization to invest in fixed assets (assets the organization intends to keep for more than one year) and working capital (money tied up in the day to day operations of the business).

CAPITAL

See capital employed.

CAPITAL ASSET

Assets such as property, plant and equipment employed to generate income.

CAPITAL EMPLOYED

Synonyms: *capital*

Capital employed represents the funds provided to an organization in the form of equity or debt.

CAPITAL IN EXCESS OF PAR VALUE

See contributed surplus.

CAPITAL STOCK

Synonyms: *stock, shares, share capital*

There are two types of stock - common stock and preferred stock. Most shares tend to be common stock and generally carry one vote each and carry an equal right to a proportionate share of dividends. Capital stock is not a liability in the sense of other sources of funds (e.g. bank loans) since it is not generally paid back to shareholders unless the company is wound up.

CASH FLOW STATEMENT

The cash flow statement is a 'summarized bank statement' that shows an organization's sources of cash during the financial year and the ways in which the cash has been used during that period (e.g. investments, fixed asset purchases, etc.).

CIRCULAR REFERENCES

Circular references occur when a formula includes a reference to the cell in which the formula appears.

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COGS

Cost of goods sold.

COMMON SHARES

See common stock.

COMMON STOCK

Synonyms: common shares, ordinary shares

Most shares tend to be common stock carrying one vote each and with an equal right to a proportionate share of dividends. Common stock dividends tend to rise as profits grow. This is in contrast to preferred stock where the dividend tends to be fixed.

CONTRIBUTED SURPLUS

Synonyms: share premium, capital in excess of par value

Most stock is originally issued with a nominal/par value attached to it (e.g. 1 share in ABC Inc. has a nominal value of \$1.00). However, if shareholders buy shares from the company for more than the nominal value (e.g. \$1.50) the excess is called the contributed surplus.

COVERAGE RATIOS

Ratios that analyze a company's liquidity or its ability to "cover" its financial debt obligations. An example of a coverage ratio is EBITDA / Interest expense.

CREDITORS

See accounts payable.

CURRENT ASSETS

Current assets are all assets other than fixed assets. They are either cash or assets expected to be converted into cash or consumed in the business during the year. Current assets include items such as cash, accounts receivable and inventory.

CURRENT LIABILITIES

An organization's liabilities due within one year. Current liabilities include items such as short term loans, any element of long term loans due within one year, and accounts payable.

CURRENT RATIO

Current assets / current liabilities. This ratio measures short term liquidity, whether or not a company will have the ability to cover its obligations in the short term.

DCF

Discounted cash flow analysis. A financial evaluation method that takes the "time value of money" into account.

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DEBT

Capital used to finance an organization that is subject to payment of interest over the life of the loan, at the end of which the loan is normally repaid.

DEBT FINANCING

Raising money for a business through loans or by issuing bonds.

DEBTORS

See accounts receivable.

DEPRECIATION

Synonyms: *amortization*

Depreciation of fixed assets is the process of allocating part of the cost of fixed assets to a particular accounting period. Depreciation is normally charged to the income statement on a straight line basis (although there are alternative methods available). For example, if a car is bought for \$15,000, has an expected life of 5 years, and has a residual value (expected scrap value) of \$5,000, then the depreciation expense in the income statement will be \$2,000 per year for 5 years. The value of the car in the balance sheet would start at \$15,000 but would be reduced by \$2,000 a year. At the end of year 1 the net book value (NBV) of the car in the balance sheet would be \$13,000. At the end of year 2, the NBV would be \$11,000. The accumulated depreciation for the car at the end of year 2 would be \$4,000.

DIRECT COSTS

Direct costs are those that are directly attributable to the product or service provided by the organization. They are included in cost of goods sold.

DIVIDENDS

A share of a company's net profits distributed by the company to a class of its stockholders.

EBIT

Earnings before interest and taxes. See operating profit.

EBIT MARGIN

EBIT / Sales.

EBITDA

Earnings before interest, taxation, depreciation, and amortization.

EQUITY

Synonyms: *shareholders' equity, shareholders' funds*

Total assets less total liabilities. Also called shareholders' equity, net worth or book value.

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EQUITY FINANCING

The money acquired from the business owners themselves or from other investors.

FINANCIAL COVENANTS

The promises made by the borrowing firm in a loan agreement to adhere to certain limits in the firm's operations.

FINANCIAL MODEL

A mathematical model describing the interrelationships among various financial variables. Typically financial models are broken down into inputs, processing, and outputs.

FINANCIAL STATEMENTS

Statements, in financial terms, of the financial position of an entity at a given date, or of the results of its operations for a given period. The statements are normally prepared in one of a number of standard formats. Most commonly, when people refer to financial statements, they mean the income statement, the balance sheet, the cash flow statement and the related notes to the accounts.

FIXED ASSETS

Assets intended for use on a continuing basis in an organization's activities (normally defined as assets an organization intends to keep for more than one year). There are three categories of fixed assets: intangible, tangible and investments.

FORECAST

The projection or estimate of future sales, revenue, earnings, or costs.

GOODWILL

When one company buys another company it typically pays more than the book value of the net assets acquired (because it is acquiring staff, name / reputation, and customer relationships). This excess of the purchase price over the fair book value of the net assets is called goodwill. Goodwill is normally included in the balance sheet as an intangible fixed asset.

GROSS MARGIN

Gross profit / Sales revenue. Gross margin shows how much was spent producing the good or service that was sold for every dollar of sales revenue.

GROSS PROFIT

Sales revenue less cost of sales.

INCOME STATEMENT

Synonyms: *profit and loss account, P&L statement, statement of earnings*

The income statement is an organization's 'financial history book' and summarizes the revenue, expenses and operating profit for the financial year. It also shows the tax charged against profit, how much of the profit for the year has been paid out in dividends and how much has been retained in the business.

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INPUTS

Financial model assumptions that are used to drive model outputs.

INTANGIBLE FIXED ASSETS

Intangible fixed assets have no 'physical' presence. Examples include patents, goodwill, trademarks and brand names.

INTEREST BEARING CURRENT LIABILITIES (IBCL'S)

These are liabilities that bear interest, normally short term borrowings. They are excluded from some ratios in order to factor in the cost of financing.

INTEREST COVER RATIO

EBITDA / Interest expense. This solvency ratio shows how much income is available to service debt costs.

INVENTORY

Inventory normally refers to items held for resale and may include raw materials, work in progress and finished goods.

INVENTORY DAYS RATIO

Inventories / COGS x 365. Average number of days goods remain in inventory before being sold.

INVENTORY TURNOVER RATIO

Sales / Inventory (either the ending balance, or average inventory balance). This ratio illustrates how a company manages its inventory.

INVESTING ACTIVITIES

Deals or transactions involving sale or purchase of equipment, plant, properties, securities, or other assets.

LABOUR COST RATIO

Direct labour / Sales. Cost of goods sold is made up of labour, materials, and direct costs. This margin shows the proportion of labour that goes to make up each dollar of sales.

LAND AND BUILDINGS RATIO

Sales / Land and buildings. The sales generated from land and buildings is measured by this ratio.

LEVERAGE RATIOS

Ratios that analyze a company's solvency or the level of its debt financing relative to its equity financing. An example of a leverage ratio is Total debt / Total shareholders' equity.

LIABILITIES

Money owed, or other financial obligations to other organizations, liabilities and individuals.

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LOAN CAPITAL

See debt.

MATERIAL COST RATIO

Materials / Sales. Cost of goods sold is made up of labour, materials, and direct costs. This margin shows the proportion of materials that goes to make up each dollar of sales.

MODEL STRUCTURE

The framework around which a financial model is built.

NET ASSET RATIO

Sales / Net assets. This ratio takes into account the financing of assets, and measures management's efficiency in relation to the use of assets.

NET ASSETS

Total assets less total liabilities.

NET BOOK VALUE

Net book value typically refers to property plant and equipment (PP&E). The net book value of PP&E is calculated by taking the total gross cost of PP&E and deducting total accumulated depreciation / amortization.

NET EARNINGS

Synonyms: *net income, retained profit for the year, retained earnings for the year*

The profits retained by an organization after all expenses including interest expenses, taxes and dividends. The retained profits / earnings for a given year are reinvested in the business (hopefully making the organization grow, and increasing the value of its shares) and are added to 'retained earnings' in the balance sheet (which represent all retained profits accumulated over an organization's entire life to date which have been reinvested in the business).

NET INCOME

See net earnings.

NET PROFIT MARGIN

Net income / Sales. This margin shows how much is earned for every dollar of sales revenue.

NON-CURRENT ASSETS

Assets that are not expected to be converted into cash within 12 months of the balance sheet date.

OPERATING ACTIVITIES

Synonyms: *earnings before interest and income taxes (EBIT), profit before interest and income taxes (PBIT)*

Cash inflows and outflows relating to a company's operations. Examples includes receiving payments from customers, paying salaries, etc.

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OPERATING ASSETS

Assets acquired for or used throughout the operations of the business (such as cash, inventory, prepaid expenses, equipment).

OPERATING COST RATIO

Operating costs / Sales. This margin shows the operating expenses as a percentage of sales. This does not include cost of goods sold (as is the case with the operating profit margin), so is an indication of the efficiency of the operation.

OPERATING PROFIT

Synonyms: *earnings before interest and income taxes (EBIT), profit before interest and income taxes (PBIT)*

Sales revenues less all operating expenses. Operating profit is calculated before financing costs and taxes. It is often referred to as EBIT.

OPERATING PROFIT MARGIN

Otherwise known as the EBIT margin. Operating income / Sales. This performance ratio shows the cost of running the operation for each dollar of sales.

OPERATING REVENUES

The net sales revenue accumulated by a firm.

ORDINARY SHARES

See common stock.

OUTPUT

Financial model calculations that are driven by one or more inputs.

PERSONNEL COST RATIO

Personnel costs / Sales. The personnel costs used in this ratio could be research and development specific, or general overhead personnel costs, or total personnel depending upon the type of organization. This margin is useful in monitoring the amount spent on wages, salaries, and related expenses for each dollar of sales.

PLANT AND MACHINERY TURNOVER RATIO

Sales / Plant and Machinery. This ratio measures the efficiency of the company's operating assets.

PREFERRED STOCK

Synonyms: *preference shares*

Preferred stock has preferential rights over common stock to both dividends and also to assets in the event that a company is wound up (i.e. preferred stock holders are paid out before common stock holders). Typically preferred stock dividends are fixed (e.g. 6 percent preferred stock) and do not increase with rising profits.

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PROCESSING

The translation of financial model inputs or assumptions into financial model outputs.

PROPERTY, PLANT AND EQUIPMENT (PP&E)

Non-current fixed or capital assets such as buildings, computers, land, and vehicles.

PROPERTY, PLANT AND EQUIPMENT (PP&E) TURNOVER RATIO

Sales / Property, Plant & Equipment. This ratio measures the sales a company is able to generate from capital assets.

QUICK RATIO

Current assets - Inventory / Current liabilities. This ratio provides a more prudent measure of short-term liquidity recognizing the inventory can not always be readily converted into cash.

RESEARCH AND DEVELOPMENT COST RATIO

Research and development costs / Sales. This margin shows how much the company invests in developing the next generation of products or services for each dollar of sales.

RESEARCH AND DEVELOPMENT EXPENSES

These expenses are directly attributable to researching and developing new or improved products or systems.

RESERVES

Reserves are part of shareholders' equity. Reserves are subdivided into revenue reserves (e.g. retained earnings), which are available to be distributed to the shareholders by way of dividends, and capital reserves (e.g. contributed surplus), which for various reasons are not distributable as dividends.

RETAINED EARNINGS (BALANCE SHEET)

Synonyms: P&L reserve, Retained earnings reserve

Retained earnings in the balance sheet represent all retained profits accumulated over an organization's entire life to date which have been reinvested in the business. As the retained earnings ultimately belong to shareholders, they are included as part of shareholders' equity.

RETAINED EARNINGS (INCOME STATEMENT)

See net earnings.

REVENUE

Synonyms: sales, sales revenue, turnover

Revenue includes both cash sales and credit sales of goods and services, but does not include the sale of fixed assets.

SALES

See revenue.

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SELLING COST RATIO

Selling costs / Sales. This margin shows how much it costs to sell each dollar of sales.

SG&A (SELLING, GENERAL, AND ADMINISTRATION)

Operational expenses that include direct and indirect selling expenses and all general and administrative expenses. Rent, heat, lights are all examples of general expenses.

SHARE CAPITAL

See capital stock.

SHARE PREMIUM

See contributed surplus.

SHAREHOLDERS' EQUITY

See equity.

SHARES

See capital stock.

STATEMENT OF EARNINGS

See income statement.

STOCK

See capital stock.

STOCK REPURCHASES

When a corporation buys back its own shares in the open market.

TANGIBLE FIXED ASSETS

Synonyms: capital assets

Tangible fixed assets are fixed assets that have physical presence and include things like land, buildings, machinery, equipment, computers and so on.

TAX EXPENSE

The tax liability that companies, and individuals, are required to pay by law.

TAX RATIO

Tax / Sales. This efficiency ratio shows how well management is managing tax.

TURNOVER

See revenue.

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TURNOVER RATIO

Ratios that measure an assets' activity or efficiency in generating revenues or cash. $\text{Total assets} / \text{Sales}$.

WORK OVERHEAD RATIO

Direct overhead / Sales. Cost of goods sold is made up of labour, materials, and direct costs. This margin shows the proportion of direct overhead that goes to make up each dollar of sales.

WORKING CAPITAL

Working capital is normally defined as money tied up in the day to day operations of an organization. It is approximately equal to current assets less current liabilities. However, many analysts will define working capital more explicitly as inventory and accounts receivable less accounts payable (and exclude other current assets / liabilities such as cash and non-trade receivables and payables).