

FINANCE 101: TERMS EVERY SMART INVESTOR SHOULD KNOW

Finance made easy for everyone

Part 1 of the Investor Essentials Series



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What you'll learn:

- ✓ The difference between cash flow and profit
- ✓ Why EBITDA matters to investors
- ✓ How compound interest can build wealth
- ✓ How depreciation affects profit and asset values over time

In investing, knowledge is not only power but profit as well. Whether you're a student, someone curious about finance, or an investor, understanding basic financial terms can help you make smarter decisions.

In this article, the first in the *Investor Essentials* series, I break down 5 foundational finance terms per article that every investor should know. Each term is explained in simple language with real-world examples, along with practical tips to help you navigate your investment journey.

Disclaimer: This article is for educational purposes only and reflects my personal understanding of the concepts. It is not intended as financial advice. Please do your own research and consult a professional advisor before making investment decisions.

Term #1 EBITDA

What is EBITDA?

- EBITDA stands for Earnings Before Interest, Tax, Depreciation, and Amortization.
- It shows us how much money a company makes just from running its main business without counting loans or taxes.

Why does it matter to investors?

- It helps investors to evaluate a company's operational profitability by focusing solely on its core activities, without the influence of interests, taxes, or non-cash expenses.

How to calculate it?

- **EBITDA = Net Income + Interests + Taxes + Depreciation + Amortization**

Example:

- Let's say a company has:

-Net Income: \$200,000	-Depreciation: \$40,000
-Interest: \$50,000	-Amortization: 20,000
-Taxes: \$70,000	

$$\begin{aligned} \text{EBITDA} &= \$200,000 + \$50,000 + \$70,000 + \$40,000 + \$20,000 \\ &= \$380,000 \end{aligned}$$

Term #1 EBITDA

Knowledge Point 

EBITDA helps compare companies in capital-intensive industries. However, some companies may use it to make their financials look healthier than they really are.

Term #2 Cash Flow

What is Cash Flow?

- It represents the net amount of cash and cash equivalents being transferred into and out of the business.

Why does it matter to investors?

- Investors use Cash Flow to determine a company's financial health and liquidity, beyond just the profit. A strong Cash Flow statement indicates that the business can pay its bills, invest and grow.

How to calculate it?

- Cash Flow = Cash Inflow - Cash Outflow

Example:

- If a company earns \$500,000 from sales and spends \$300,000 on expenses, then Cash Flow = \$200,000.

Knowledge Point

Profit is what's left after all expenses are subtracted from the revenue. In comparison, Cash flow is the actual movement of money into and out of the business.

Term #3 Amortization

What is Amortization?

- Amortization is the gradual reduction of an intangible asset's value over time or the scheduled repayment of a loan through regular installments over a fixed period.

Why does it matter to investors?

- Investors track amortization to understand how intangible assets like patents, trademarks etc, impact financials and how debt obligations are being repaid.

How to calculate it?

Amortization of intangible assets:

- Amortization = Cost / Useful Life

Loan Amortization:

- $A = P \times [r(1 + r)^n] / [(1 + r)^n - 1]$

Where:

- A = monthly payment
- P = principal loan amount
- r = monthly interest rate (annual rate \div 12)
- n = number of months

Term #3 Amortization

Example:

Amortization of intangible assets:

- Patent cost: \$50,000
- Useful life: 10 years
- Residual value: \$0
- Amortization = $\$50,000 / 10 = \$5,000$ per year

Loan Amortization:

- Loan: \$10,000
- Interest: 6% annual (0.5% monthly)
- Term: 24 months
- $A = 10,000 \times [0.005(1 + 0.005)^{24}] / [(1 + 0.005)^{24} - 1]$
- $A \approx \$443.21/\text{month}$

Knowledge Point

Amortization helps businesses spread out the cost of intangible assets over their useful life, allowing for a smoother and more accurate financial reporting. It also refers to breaking down loan repayments into manageable installments, separating interest from principal over time.

Term #4 Depreciation

What is Depreciation?

- It is the accounting process of allocating the cost of a tangible asset over its useful life
- Depreciation is recorded as an expense on the income statement, even though no cash leaves the company. This reduces the company's **net income** each year.
- Over time, depreciation also reduces the **book value** of fixed assets (like machinery, vehicles, or buildings). This reflects the fact that assets lose value as they age and get used.

Why does it matter to investors?

- Depreciation helps investors understand how much a company's equipment and assets are aging or wearing out over time.
- It also impacts net income by reducing taxable earnings. This means that the company pays less in taxes and can potentially retain more cash.
- This gives investors insight into:
 - How efficiently are assets being used
 - Whether major replacements or upgrades may be needed soon

Term #4 Depreciation

How to calculate it?

Straight Line Method (SLM):

- Depreciation Expense = (Cost of Asset – Salvage Value) ÷ Useful Life

Other methods to calculate Depreciation:

- Declining Balance Method
- Units of Production
- Double Declining Balance (DDB)

Example:

- If a machine costs \$50,000, with a salvage value of \$5,000 and a 5-year life,
- Annual depreciation = $(\$50,000 - \$5,000)/5 = \$9,000$.

Knowledge Point

Always check the depreciation line on the cash flow statement and the accumulated depreciation on the balance sheet. It tells you a lot about a company's financial strategy and how fast its assets are aging.

Term #5 Compound Interest

What is compound interest?

Compound interest is the interest that is calculated on the principal amount and also on the accumulated interest of the previous periods.

Simple vs. Compound Interest:

- Simple Interest: Earned only on the original amount.
- Compound Interest: Earned on the original amount plus all the interest you've already earned.

Why does it matter to investors?

Compound interest accelerates investment growth over time, allowing investors to earn interest on interest.

How to calculate it?

$$\text{Compound Interest} = P \times (1+r)^t - P$$

Term #5 Compound Interest

Example:

If you invest \$1,000 at 5% annual interest compounded yearly for 3 years:

$$CI = 1000 \times (1 + 0.05)^3 - 1000$$

$$= 1000 \times (1.157625) - 1000$$

$$= \$157.63$$

Knowledge Point

The real power of compound interest isn't just the rate; it's the time. Even small amounts invested earlier can outperform larger amounts invested later. It's not how much you invest, but how long you let it grow that builds real wealth.

COMING UP IN PART 2

In Part 2 of the Investor Essentials series, we'll explore five more powerful terms like

- *ROI*
- *Equity*
- *Liquidity*
- *Dividends, and*
- *Profit Margin*