A Pocket Dictionary of Basic Financial Terms for Small Business

Studies show that many Business Owners are not reviewing their Financial statements … WHY? It's because they do not understand all of the financial terminology.
If you struggle to understand financial lingo, this list of common financial terms and definitions may help. Use it as a reference while you are working with your accountant, business coach, or while going over your books each week. And it's okay to admit that you don't know all of the terms…You are not alone!

Accounts Payable
Accounts payable is also called trade payable. It refers to the total invoices for goods and services a business has received but has yet to pay. They are usually due for payment within 15 to 45 days. In short, this is money your business owes to vendors, suppliers, and other businesses.

Accounts Receivable
Accounts receivable is the amount of money a company has claim to or has invoiced. It is from having sold goods or rendered services to its customers. This is what other businesses or customers owe your business.

Accrued Expenses
Accrued expenses are expenses that a business has incurred but has yet to pay. This is because either the invoices have not yet been received or the payments are not yet due. Accrued expenses are generally created by an accounting entry to reflect these liabilities.
Examples of accrued expenses include interest on loans and taxes incurred. Salaries your employees earn up to the period of reporting but are not due for payment until after the report is prepared, are also accrued expenses.

Assets

An asset is any item your business owns that is of fiscal value and is expected to benefit the business in the future.

Balance Sheet

Your balance sheet gives an overview of the financial condition of your company. Unlike an income statement, a balance sheet offers a snapshot of a business's finances at a specific moment in time.

A balance sheet consists of three segments:

1. Assets
2. Liabilities
3. Owner's Equity

These three segments must balance out in this simple equation:

Assets = Liabilities + Owner's Equity

Thus, the name balance sheet. There is more to follow regarding these terms.

Cash and Cash Equivalents

Cash and cash equivalents are assets and items that a business can easily convert into cash. Cash equivalents could include checks, certificates of deposit, and treasury bills. If your business does not have cash equivalents, it would only report its cash-on-hand and what's in the bank.

Cash Flow

Cash flow refers to the stream of cash moving into and out of a business. When a business receives more cash than it sends out, it is cash flow positive. A business is cash flow negative when it spends more than it receives.

Cost of Goods Sold or Cost of Revenue

Cost of goods sold refers to the full cost for the production of the goods a business has sold. The only costs included are those that are directly related to the production of the products, including the cost of labor, materials, and manufacturing overhead to name a few.

Gross Profit

Gross profit is the cost of goods sold or cost of revenue subtracted from net sales and excludes operating expenses that do not directly generate revenue such as accounting, supplies, and advertising. It is the first element of how profitable a company is. It indicates the profitability of the products and services the company offers before considering operational expenses.

Gross Profit Margin

Gross profit margin refers to the ratio of the revenue that you keep as gross profit. It is also called gross margin or gross profit percentage.

The formula to calculate this is: (Gross Profit ÷ Net Sales) x 100

Example: A pet food business whose gross profit is $20,000 with net sales of $50,000 has a gross profit margin of 40%. This means the pet food that was sold returned 40% on the capital that's directly associated with the pet food production.

Gross Sales

Gross sales include the total of all sales activity during a reported period. It excludes sales deductions such as sales discounts, sales returns, and sales allowances.

Income Statement

Your income statement is also called a profit and loss (P&L) statement or earnings statement. An income statement shows all the money your business makes (i.e. profit) ... Income statements are generated monthly, quarterly, or annually depending on the company and usually include comparative figures from prior periods.

Liabilities

A liability refers to any financial amount a business owes. This includes trade and accounts payable, accrued expenses, loans, mortgages, and even advance payments received from customers for goods and services not yet delivered or rendered. Liabilities are reported on balance sheets as short-term (current) and long-term liabilities. Current liabilities are typically obligations that are due within a year.

Net Income

Net income is gross profit minus all other expenses incurred during the reported period and also reflects any additional non-recurring income and expenses.

It is the overall determining factor of how profitable a business is. Here's an example… If your gross profit is $20,000, and you spent $10,000 on operating and non-operating items, your net income would be $10,000.

Non-Operating Expenses and Loss

Non-operating expenses are costs incurred due to activities <u>unrelated</u> to a business's core operation. These activities do not have tangible effects on operating results. This includes, but is not limited to, interest and insurance. A non-operating loss is loss incurred from activities that do not relate to business operations. A good example would be a loss incurred as a result of a lawsuit settlement.

Non-Operating Revenue and Income

Non-operating revenue and income is the total profit created by a business from activities that are not tied to its core operations. Examples would include proceeds from selling business equipment or realizing a gain on a special transaction.

Notes Payable and Notes Receivable

Notes payable are amounts due to other parties outside of your usual trade and accounts payables. These could be funds borrowed from a bank or an amount owed to a supplier for raw materials delivered. Notes payable are a debt instrument. They are recorded as a current liability on a balance sheet if due within 12 months. An example of a notes payable is a loan issued to a company by a bank.

Notes receivable is the opposite of notes payable and represents amounts owed to you that are outside typical customer receivable transactions. Examples may include loans made to employees or shareholders. Notes receivable appear as a current asset on a balance sheet if expected within 12 months.

Operating Expenses

Operating expenses are the costs tied to a business's core operations outside of production costs, which are generally classified as cost of goods sold. Operating expenses include selling, general and administrative expenses that are not directly related to the production of the company's products or services.

Owner's Equity

Owner's equity is the full amount of the owner's investment into the business. This is the portion of assets that belongs to the business owner. It is derived by deducting total liabilities from total assets. Owner's Equity is not the fair market value of a business.

Operating Income

Operating income is the revenue or net sales that's left after you deduct operating costs. It is also called operating profit or earnings before interest and taxes (EBIT). Its calculation excludes non-operating expenses like interests, taxes, lawsuit settlement expenses, etc.

Operating Margin

Operating margin is the ratio of revenue or net sales a business keeps as operating income. It is calculated by dividing operating income by revenue or net sales. The result is then presented as a percentage by multiplying by 100.

For example, a business's operating income was $10,000 on a $50,000 revenue or net sales. Its operating margin is then ($10,000 ÷ $50,000 = 0.2) x 100 = 20%.

Operating margin helps determine how efficient a company's day-to-day operations are. In the example above, the business's day-to-day operation made $0.20 for each dollar of revenue.

Prepaid Expenses

Prepaid expenses usually arise when businesses pay in advance for goods and services needed in the near term. Prepaid expenses usually appear on a balance sheet in the current assets' subsection. This is because they're usually due within 12 months.

Insurance is one example of a prepaid expense. For example, assume your business pays up front for an insurance policy of $2,400 with a 12-month term. You will initially have a $2,400 prepaid expense asset on your balance sheet. As each month passes over the 12-month period, you will reduce this asset by $200 and record an expense until the expense has been equally recognized over the course of the term. Other typical prepaid expenses include rent, supplies, legal and other products, or services paid for in advance.

Revenue

Revenue is the total amount of money a company brings in from its business activities <u>after</u> discounts, returned goods, and other sales allowances have been deducted. Businesses that sell goods, such as retailers, are more likely to refer to revenue as net sales. It is also called top-line because it usually appears at the top of an income statement.

Selling, General, and Administrative Expenses (SG&A)

Selling, general, and administrative expenses are expenses you incur while selling your products and services. They also include the cost of running your business on a daily basis. Here is a breakdown:

Selling expenses include the cost to sell the goods you have already produced or purchased. This excludes cost of production or purchase. It includes expenses related to sales material, traveling, advertising, delivery, warehousing, telephone bills, salaries of sales employees, and sales commission.

General and Administrative expenses are usually more fixed than selling expenses. They include expenses related to rent, mortgage, insurance, utilities, and salaries of non-production and non-sales employees.

Unearned Revenue

Unearned revenue refers to advance payments a business receives from its customers. It is also called deferred or prepaid revenue. It is considered a liability because you received the payment but have not delivered the product or service yet.

Unearned revenue is treated similar to prepaid expenses. Whereas the prepaid asset is reduced, and the expense is incurred monthly over the period of a contract the opposite is true for unearned revenue. In this case, income is incurred evenly over the period of a contract and the liability is reduced accordingly.

Managing your finances is one of the most important parts of running a business. Unfortunately, small business owners who have little financial background sometimes avoid these responsibilities. By learning these key financial terms, you will be more able to understand your financial statements, communicate with finance professionals, and monitor your business's cash flow more closely.

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