The Pharmacy Guild of Australia

SmallBusiness

FACT SHEET: Business financial terms and ratios
Useful definitions

These financial terms and ratios are the most commonly used financial terms that you may come across when you are dealing with accountants and financial institutions, or while running your business. They are based on Balance Sheet, Profit and Loss Account, and Cashflow Statement conventions.

Certain financial terms often mean different things to different businesses 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 organization 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). Also referred to as the Quick Ratio.

Assets: anything owned by the business having a monetary value; e.g. 'fixed' assets like buildings, plant and machinery, vehicles and potentially including intangibles like trademarks and brand names, and 'current' assets, such as stock, debtors and cash.

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Asset turnover: measure of operational efficiency - shows how much revenue is produced per dollar 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 business along with the Profit and Loss Account and the Cashflow Statement. The Balance Sheet is a 'snapshot' in time of who owns what in the company, and what assets and debts represent the value of the business. (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, cash on hand, etc. 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 business is making (the P&L does this), although previous years' retained profits will add to the business' reserves, which are shown in the balance sheet.

Cashflow: 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.

Cashflow statement: one of the three essential reporting and measurement systems for any business. The cashflow statement provides a third perspective alongside the Profit and Loss account and Balance Sheet. The Cashflow 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 business 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

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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.

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.

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'.

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

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side of the balance sheet will show Current Liabilities along with various Assets, showing where the money is now.

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.

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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.

Overhead: an expense that cannot be attributed to any one single part of the business activities.

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.

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