# Glossary of Accounting Terms

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# Introduction

We have compiled this glossary of terms to assist you to understand the “jargon” which *is* used in business and investment.  This glossary is limited to Accounting Terms but we publish several other glossaries as well – check our website or call us for details.

# Accounting Terms

- **Absorption Costing** - a system of costing whereby products and services absorb a share of indirect costs such as insurance and rent in addition to their direct costs such as labour and raw materials. A direct cost can be specifically allocated to a product or service. An indirect or overhead cost such as the rent for a factory or an office cannot be directly attributed to a product or service.
- **Accounting Policies** - the specific approaches or methods chosen by companies to account for certain items, for example, the valuation of stocks or inventories and the calculation of depreciation.
- **Accounting Standards** - The accounting rules and guidelines issued by the Accounting Standards Board (ASB). The ASB reports to the Financial Reporting Council. New International Financial Reporting Standards came into effect during 2005.
- **Accounts Payable** - the US term for trade creditors – amounts due to suppliers.
- **Accounts Receivable** - the US term for trade debtors – amounts due from customers.
- **Accruals and Accrued Charges** - accruals / accrued charges are expenses such as rent and utility costs that have been included in a period’s profit and loss account but have not been paid during the period.
- **Accrued Income -** accrued income is the opposite of an accrued charge. For example, cash received in advance from customers but before goods or services have been provided. Accrued income is treated as a current liability.
- **Accruals Basis** - an accounting convention in which transactions are reflected in the accounts of the period in which they take place, as opposed to the period in which payments are made or received.
- **Accumulated Depreciation or Amortisation** - the total depreciation or amortisation deducted from or provided against a fixed asset since the date it was purchased.
- **Acid-Test (or Quick Ratio or Liquid Ratio**) – this measures the ability of a company (and thus its strength) to use its near cash or quick assets to immediately extinguish or pay its current liabilities. This ratio is the most stringent measure of how well a company is covering its short-term commitments.
- **Activity Based Costing** - a technique for charging indirect costs such as purchasing to products and services. The factors affecting the level of indirect costs, for example, the number of purchase orders and the number of machinery set-ups are called cost drivers.
- **Amortisation** - the write off (or spread) of the cost of Intangible Assets over an agreed period, based on life expectancy or obsolescence. The term is also used to apply to a reduction in debt by periodic payments covering both interest charges and part of the principal.
- **Annual Report & Accounts (also known as Financial Statements) -** these comprise the directors’ report to shareholders setting out, in both text and financial terms, details of the company’s performance during the past year and the state of its finances and assets at the end of the financial year.
- **Assets** - Anything owned by the company having a monetary value; eg, 'fixed' assets like buildings, plant and machinery, vehicles (these are not assets if rented and not owned) and potentially including intangibles like trade marks and brand names, and 'current' assets, such as stock, debtors and cash.
- **Asset Turnover** - a performance measure used to assess the effectiveness with which a business uses its assets. It is calculated by dividing sales by capital employed. The higher the figure the better.
- **Associated Companies** - where a company has an interest in another company that represents more than 20%, but less than a majority, of the voting rights in that company’s share capital, then this is called an investment in an “Associated Company”. The profits of the investment are consolidated into the results of the investment holding company. Under a 20% interest only dividends received will feature in the holding company’s accounts. Over a 50% interest, the investment is deemed to be a subsidiary company and its results and net assets will be fully consolidated in the holding company’s own accounts.
- **Audit** - the annual inspection of a company’s financial records and its financial statements conducted by an independent firm of registered auditors.
- **Auditors** - independent accountants appointed by a company’s

shareholders. Auditors are usually recommended by the company's directors, subject to approval by shareholders, at the Annual General Meeting.

- **Audit Committee** - a sub-committee of the board of directors. It is responsible for monitoring all the reporting, accounting, control and financial aspects of management activities.
- **Audit Report** - the report on the 'truth and fairness' of financial statements. It is addressed to shareholders and prepared by the auditors.
- **Authorised Share Capital** - the total number of shares a company is authorised to issue by its Memorandum and Articles of Association. The amount of issued share capital must be equal to or less than the authorised share capital, i.e. a company cannot issue more shares than it is authorised to issue in its Articles.
- **Balance Sheet** - this is the statement featured in the Annual Report & Accounts that indicates the carrying value (but not necessarily the market or realisable value) of the company's assets and liabilities as at the end of its financial period (the Balance Sheet date) together with liabilities including financing debts and share capital.
- **Book Value** - the value of an asset as recorded in the financial statements. For a fixed asset it will be the original cost (unless amended by revaluation) less the depreciation that has so far been accumulated on it. This is called the net book value or written down value. The book value of an ordinary share is the sum of the ordinary share capital and reserves (the equity) divided by the number of issued shares.
- **Bond or Note** - interest bearing liabilities issued by organisations. They are a source of long term finance.
- **Break-Even Point** - the level of output or revenues at which total revenues equal total operating costs. Total operating costs are all costs excluding financing charges and tax.
- **Budget** - an annual (but it may be longer or shorter) financial plan covering; sales and costs, capital expenditure, cash inflows and outflows, assets and liabilities. It is a commitment to achieve a set of results during a specific future period.
- **Budgetary Control** - a short term financial planning system designed to ensure that actual results during the financial year are measured against the budgeted results. The differences or variances are then investigated and corrective actions are taken to ensure that, for the period as a whole, actual performance is as close to the budget as possible.
- **Capital Allowances** - in the UK, it is HMRC's equivalent of a company's depreciation charge. Depreciation is not an allowable expense deduction for tax purposes in the UK but capital allowances are granted on the purchases of certain fixed assets such as plant and machinery and industrial buildings. They have the effect of reducing taxable profit.
- **Capital Expenditure** - expenditure on fixed assets such as plant and equipment and on acquisitions, mergers and other long-term investments such as joint ventures. Net capital expenditure is capital expenditure less the cash proceeds from fixed asset and/or business disposals.
- **Capital Employed** - the funds employed by the company in its activities. This represents the value, in the Balance Sheet, of the company's share capital, reserves and debt. It can be expressed either before or after intangible assets, dependent upon the circumstances and requirement.
- **Capital Gearing or Gearing** - the proportion of borrowings in relation to Equity. It is commonly measured by the debt to equity ratio. The higher the debt/equity ratio, the higher a company's gearing. For this purpose, debt is normally defined as total borrowings or interest bearing obligations including leases less (a) cash balances and, (b) short-term investments such as cash deposits. In US terminology, gearing is known as financial leverage.
- **Capitalisation (or Market Capitalisation)** - the value of a company's equity based on the market price of its shares; it is, therefore, equal to the number of shares issued times their market price. Market capitalisation can be used to include the market value of all the company's traded securities, including bonds and debentures. Strictly speaking, this should be referred to as the enterprise value.
- **Capitalise** - this has a number of meanings: (1) the interest payable on borrowings for a building or maintenance expenditure on equipment is capitalised if, instead of being charged to the profit and loss account, it is added to the capital cost of the project or the equipment. In this sense, 'to capitalise' means to treat as an asset. The capitalised amount is depreciated as if it were a fixed asset. (2) Reserves are capitalised when retained profit is converted into share capital by way of a scrip or bonus issue. (3) to "capitalise a company" means putting cash into it in the form of share capital.

- **Capital and Reserves** - the proportion of a company’s financing provided by shareholders. It consists of issued share capital, share premium, retained profit or retained earnings and any other reserves. Other terms for capital and reserves include equity, shareholders’ interest, shareholders’ funds, equity shareholders’ funds, net assets and net worth.
- **Capital Budgeting** - this is the process for deciding how much will be spent on fixed assets in a particular financial period including an assessment of the financial viability of projects.
- **Capital Rationing** - a situation when there are more capital expenditure projects to invest in than there is cash available to finance them.
- **Capital Redemption Reserve** - this is a special type of reserve and, therefore, part of a company’s equity. It is created when a company purchases some of its own shares – a share buy-back. A capital redemption reserve must be set up and be equal to the nominal value of the shares purchased.
- **Capital Structure** - this is the relative proportions of debt and equity in a company’s 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.
- **Cash Flow Statement** - the statement in the Annual Report & Accounts that indicates, for the financial period, the sources of all cash, and the movement and availability of cash through and to the business.
- **Collection Period or Days Sales Outstanding** - this is the average length of time taken by a customer to pay a sales invoice. It is calculated by dividing trade debtors/receivables by annual sales times 365 days to give the average number of days for which the sales invoice has been unpaid.
- **Commercial Paper** - unsecured short-term borrowings normally for a maximum of one year.
- **Common Stock** - the US term for ordinary share capital.
- **Consistency** - a basic accounting concept – the accounting treatment of all items should be consistent from one accounting period to the next.
- **Consolidated or Group Accounts** - the financial statements are prepared for the parent company and its subsidiaries as if the parent company and the subsidiaries are all one entity. A parent company is a company which has one or more subsidiaries.
- **Contribution** - the difference between sales and direct or variable costs before charging indirect or fixed costs. Direct or variable costs may be called ‘cost of sales.’ Contribution may be called gross profit**.**
- **Contingent Liabilities** - Potential liabilities that the company could face in the future if certain circumstances should arise. Indicated in the Notes to the Accounts it will include, for example, the likely costs arising from guarantees given to third parties.
- **Convertible** - a bond, debenture, or preferred share which may be exchanged by the owner for ordinary shares in accordance with the terms of the issue.
- **Corporation Tax** - the tax levied on a company’s taxable profit. Taxable profit is not the same as the ‘profit before taxation’ in the profit and loss account because various items are allowable and disallowable for tax purposes. An example of an allowable item is a capital allowance (the taxation equivalent of depreciation to encourage capital expenditure). Examples of disallowable items are depreciation and entertainment.
- **Cost/Cost Incurred** - the charge against revenues, sales or turnover made for the use or consumption of resources during an accounting period. The cost incurred is not necessarily the same as the cash actually spent in the period in view of adjustments for depreciation, accruals and prepayments.
- **Cost Centre** - a physical location within an organisation such as a department or section where costs are accumulated.
- **Cost Code** - a numbering system used to describe the type, source and purpose of all costs and revenues.
- **Cost of Capital** - the return required by the providers of finance – lenders and shareholders – to reflect the risks they face. The weighted average cost of capital (WACC) is the required rate of return reflecting the relative proportions of funding provided by lenders and shareholders. The cost of capital is also referred to as the hurdle rate, the discount rate or the test discount rate.
- **Cost of Equity** - the return required by shareholders. It is expressed on an after-tax basis.
- **Cost of Sales or 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) which is commonly arrived at via the formula: opening stock + stock purchased - closing stock.

- **Cost Unit** - any product or service to which costs can be charged.
- **Coupon** - the interest payable on a bond and the dividend payable on Preference Shares.
- **Covenant** - a requirement imposed by a lender as part of a funding agreement. For example, a company's operating profit may have to be at least four times greater than the interest charge in order to provide the lender with an appropriate level of financial security. The relationship between the operating profit and the interest charge is called the interest cover.
- **Credit** - a term in double entry bookkeeping – for every credit, there must be a debit.
- **Credit Rating** - an assessment of a company's creditworthiness – the ability and willingness to repay its short and long-term debts. The two best known credit rating agencies are Moodys and Standard and Poors. For Standard and Poors, the highest rating is AAA. The lowest is CCC.
- **Creditors (also called Accounts Payable)** - any person or organisation to whom a company has a commitment apart from shareholders. For example, suppliers of goods for whom unpaid bills are outstanding (trade creditors) and bank borrowings. It is a legal requirement to distinguish between short-term creditors (due to be paid within 12 months of the balance sheet date) called current liabilities, and long-term creditors (amounts due to be paid after one year).
- **Creditors, Long** - these are liabilities payable more than one year after the Balance Sheet date. This includes provisions and deferred taxation, loans and debt, including convertible debt, repayable more than one year after the Balance Sheet date.
- **Cum Dividend** - the purchaser of shares receives the right to receive the next dividend.
- **Cumulative Preference Shares** - these are preference shares with the condition that if any preference dividends have not been paid in previous years then they must be paid in full before a dividend can be paid to the ordinary shareholders.
- **Current Assets** - the value of the assets held at the Balance Sheet date that are represented by cash, or can be expected to be converted into cash within the next 12 months.
- **Current Liabilities** - short-term liabilities payable on demand or within one year of the Balance Sheet date.
- **Current Ratio** - the ratio of Current Assets divided by Current Liabilities. It is a broad measure of the ability of a business to meet its short-term commitments. The Acid-Test (or Quick Ratio or Liquid Ratio) however, is a more sensitive measure.
- **Debentures** - these are IOUs issued by a company in the form of a Bond or Note issued with redemption dates a number of years into the future. Debentures are usually secured against specific assets (mortgage debentures) or through a floating charge on the company's assets.
- **Debit** - a term in double-entry bookkeeping. There are at least two entries – a debit and a credit**.**
- **Debt** - interest-bearing liabilities such as short and long-term bank loans.
- **Debt: Equity Ratio** - the relationship between debt (interest-bearing liabilities or borrowings, including lease obligations) and equity shareholders' funds. It is also known as the gearing or leverage ratio. A common definition is net debt (total borrowings less short-term deposits and cash balances) expressed as a percentage of equity. The debt-equity ratio can also be defined as net debt expressed as a percentage of net debt plus equity. Net debt plus equity is the total financing available to a business.
- **Debtors (or Receivables)** - amounts owing to the company, including the value of sales made under credit, where settlement from the customer is still awaited.
- **Deferred Taxation** - this is caused by the timing differences which arise when a transaction is recognised for accounting purposes and when it is recognised for corporation tax purposes. One of the main factors is the difference in the timing of depreciation and the permitted allowances claimed against taxable profits. These tax allowances are called capital allowances.
- **Depreciation** - as a fixed asset such as plant and machinery is used, its value falls. This is recognised as a charge in the Profit and Loss Account and as a deduction from the cost of the asset concerned in the Balance Sheet. The aim is to write down the cost, less any salvage value, of a fixed asset over its estimated useful life. It is a bookkeeping entry and does not represent any cash outlay. The most common method is either straight line depreciation whereby a fixed asset is reduced in value in equal annual instalments or by instalments on a reducing balance basis.
- **Derivative** - this is a financial instrument that a company uses to reduce or remove ('hedge') non-essential risks such as interest rate changes, foreign exchange rate movements and commodity price

fluctuations.

- **Differential or Incremental Costs and Revenues** - the costs and/or revenues of different options which are then compared to identify the differences between them.
- **Discounted Cash Flow (DCF)** - a method used to calculate the present value of cash flows from operations taking into account the time value of money. The time value of money recognises that cash received today is worth more than cash received in the future because, in the meantime, it can earn a return.
- **Dividend or Distribution** - the discretionary (except on fixed coupon shares such as Preference Shares) payment recommended by the board of directors and approved by the shareholders to be distributed pro rata among the shares outstanding. On preferred/preference shares, it is generally a fixed amount. On ordinary shares, the dividend varies with the fortunes of the company and the amount of cash available. It may be reduced or omitted if performance is poor or cash is retained to finance acquisitions and to invest in new projects. Sometimes a company will pay a dividend based on past earnings even if it is not profitable; the dividend is then said to be 'uncovered'. Dividends are sometimes paid in two instalments – an interim dividend paid during the financial year and a final dividend paid after the end of the financial year.
- **Dividend Cover** - the profit attributable to the ordinary shareholders (the earnings), divided by the total dividend. It is a measure of the security of the dividend. The higher the dividend cover, the more secure the dividend since, if earnings fall, the less likely it will be that the dividend will be reduced. An uncovered dividend will have a dividend cover of less than one. Such a situation may lead to future dividends being reduced or passed (no dividend being paid at all). An alternative to dividend cover is the payout ratio. This is the annual dividend expressed as a percentage of the earnings. For example, a dividend cover of two is equivalent to a payout ratio of 50%.
- **Dividend Yield** - the annual dividend per share expressed as a percentage of the share price. A relatively low dividend yield implies that an investor is prepared to accept a low dividend income today. The expectation is that the share price will rise since the earnings prospects of the company are perceived to be good. The expectation of an appreciation in the share price is compensation for the relatively low dividend income. A relatively high dividend yield implies that an investor is not prepared to wait for an appreciation in the share price because the outlook for earnings growth is perceived to be poor and/or the risk of holding the company's shares is perceived to be high. In both cases, an investor wants a relatively high dividend income as compensation for the uncertain future prospects.
- **Double Entry Bookkeeping** - the method of recording financial transactions whereby every item is entered as a debit or credit in one account and a corresponding credit or debit in another.
- **Due Diligence** - an independent review of a company's business and financial position before a merger or take-over deal is finalised. It covers such issues as the terms of property leases, contracts with customers and the circumstances under which lenders can call in their loans.
- **Earnings** - the profit after all costs including taxation less preference dividends and the minority interest. It is the profit attributable to the ordinary shareholders - the 'bottom line'. The US expression for earnings is 'net income'. The term 'net profit' is also used.
- **Earnings Per Share (EPS)** - the earnings divided by the number of issued ordinary shares. Growth in EPS is an important financial performance indicator. Fully diluted earnings per share is worked out after allowing for the extra shares that may be issued in the future, for example, from employee share option schemes.
- **Earnings Yield** - the earnings per share expressed as a percentage of the market price of an ordinary share. The reciprocal of the earnings yield is the price-earnings ratio (P/E ratio).
- **EBITDA** - this stands for earnings before interest, tax, depreciation and amortisation. It is equivalent to revenues less cash costs including the cost of sales. Depreciation and amortisation are non-cash charges and are, therefore, excluded from cash costs. EBITDA also equivalent to operating profit plus depreciation and amortisation. EBITDA is both a measure of profitability and an indicator of the ability of a business to generate cash from its own activities. In this context, EBITDA is sometimes referred to as 'operating cash flow'.
- **Economic Value Added (Eva) or Economic Profit** - the operating profit after tax less a capital or financial charge for the capital employed used in the business.
- **Enterprise Value** - the total value of a business. It is equal to its market capitalisation (the market value of the

equity) plus the market value of its long and short term debt.

- **Equity** - the ownership interest of ordinary shareholders in a company. It is equal to total assets less short and long term creditors. It is also referred to as net assets, net worth, share capital and reserves, shareholders' funds, the shareholders' interest, or equity shareholders' funds. Equity is equivalent to share capital plus retained profit/earnings plus other reserves, for example, a revaluation reserve.
- **EV/EBIT Ratio (Enterprise value to earnings before interest and tax)** - this valuation ratio is similar to, but somewhat simpler than EV/EBITDA, with which it shares the advantage of valuing a company regardless of its capital structure. The ratio is: *EV ÷ EBIT.* The ratio is not used much in practice. EV/EBITDA is generally preferable, but sometimes the information needed is not available: for example, when doing a sum-of-parts valuation and divisional/subsidiary depreciation and amortisation numbers are not available. The EV/EBIT ratio indicates how many times the market values the operational result of the company. A low ratio suggests poorly efficient use of a company's resources, even if its profit margin is high.
- **Exceptional Items** - unusual items in an income statement such as re-organisation and restructuring costs and significant write-downs or write-offs in the value of assets and investments. Results are often shown both before and after exceptional items.
- **Ex Dividend** - the purchaser of shares does not receive the right to receive the next dividend.
- **Expenditure or Expense** - see capital expenditure and revenue expenditure.
- **Factoring / Invoice Discounting** - the receipt of cash immediately from a specialist financing company. This is arranged against the security of approved sales invoices for a fee. In the case of factoring, the finance company runs the sales ledger and collects the cash from customers. In the case of invoice discounting, the finance company does not run the sales ledger. Instead, the client company collects cash from customers which is then banked for the account of the finance company.
- **FIFO (First-in first-out) -** a method of stock (Inventory) valuation based on the assumption that the items remaining in stock are those which were purchased most recently. This means that the oldest stock is assumed to be used first.
- **Fixed Assets** - assets used in the operation of the business and will include all tangible assets such as plant and machinery, computer equipment, land and buildings. It also includes intangible assets such as goodwill, patents and trade marks.
- **Fixed Cost -** a cost which does not vary with changing sales or production volumes, such as: property rent, permanent staff wages, and depreciation of fixed assets.
- **Fixed Charge** - a type of security for a lender. The charge is on specific assets such as buildings and machinery.
- **Fixed Investments** - investments held for long term business or investment purposes. Taken in conjunction with fixed assets, they provide the tangible asset backing for the company's liabilities and debt.
- **Flexible Budget** - a budget that changes according to the actual level of activity or output achieved.
- **Floating Charge** - a type of security for a lender. A floating charge applies to all the assets of a business.
- **Forecast** - the best assessment of what is likely to be the result for a period taking into account actual performance so far, additional information not included in the budget and other future actions that will have an impact during the financial period. By contrast, the budget is the financial plan for a period and remains unchanged.
- **GAAP -** Generally Accepted Accounting Principles. They represent the common set of standards and procedures by which audited financial statements are prepared, for example, historical cost accounting.
- **Gearing (Debt to Equity)** - the percentage that borrowings represent to shareholders funds (less intangibles) at the end of the latest and preceding financial period. The expression "Negative Equity" or "neg equity" indicates that there are actual borrowings but a negative equity base.
- **Going Concern** - the assumption on which the financial statements of a company are prepared and audited. It means the company is financially viable and can meet its commitments for the foreseeable future. If the auditors mention that the going concern principle is questionable then the company may not be financially viable. This may be the case when it is difficult to renew borrowing facilities. Specific reference to going concern is required in a company's annual report.
- **Goodwill** - this is the money paid to acquire a company that exceeds its net tangible assets value. It is also the value of a company in excess of its net assets shown in its balance sheet.

- **Gross** - usually means "before deduction of tax".
- **Gross Profit (or gross profit margin)** - this is sales less cost of goods or services sold.
- **Group Accounts (or Consolidated Accounts)** - the annual financial statements of a company and its subsidiaries.
- **Historical Cost** - this is the traditional way of valuing assets in a balance sheet and costs in the profit and loss account or income statement. The criterion for valuation is the cost at the time of purchase. This system of accounting is known as historical cost accounting (HCA). Some financial statements are prepared under HCA modified by the revaluation of certain assets, usually property, to their current value.
- **Holding Company** - the parent **company** which owns a controlling interest in one or more subsidiaries. See minority interest.
- **Income** - the US term for profit. Net Income is the profit after tax on earnings.
- **Income Statement** - see the Profit and Loss account.
- **Initial Public Offering (IPO)** - The first time a company offers its shares to the financial markets and to the general public.
- **Insolvent** - Unable to meet **commitments** as they fall due. This will happen when a company does not have enough cash to pay its cash costs and/or when a company's liabilities exceed its assets. It is an offence for a company to trade when it is insolvent.
- **Intangible Assets (Intangibles)** - the company assets that are without physical form but which represent a right or expected future benefit. Examples are Goodwill on acquisition (being the value placed on the acquired company's reputation and market presence), Brands, Patents, Intellectual Property.
- **Interest Cover** - an indicator of **solvency**. It is calculated by expressing profit before interest and taxation (the operating or trading profit) as a multiple of the interest charge. It is a measure of the ability of a business to service its financing costs from the profit it earns from its trading activities.
- **Internal Rate Of Return (IRR)** - the rate of return or discount rate used in the financial appraisal of a project which produces a net present **value** of cash flows equal to zero. It is a measure of a project's profitability. The IRR should exceed the cost of capital.
- **Inventory** - the US word for **stocks** of raw materials, work-in-progress and finished goods.
- **Investments** - long term investments are investments in other businesses such as in an Associated **Company**, a Subsidiary or a Joint Venture. They will appear under fixed assets in the balance sheet. Short term investments refer to cash balances that are placed on deposit to earn a return. They will appear under current assets in the balance sheet.
- **Joint Venture** - a long-term **investment** – an investor shares control with one or more other parties under a contractual arrangement. The arrangement is referred to as a joint venture.
- **Journal Entry** - transferring an item from one account to another. For example, correcting an error by transferring an amount for insurance premiums to salaries if the figure for insurance premiums has been overstated and the amount for salaries has been understated.
- **Lease** - the hire of a fixed asset such as plant and machinery from a leasing company - the lessor. There are two sorts of leases. An operating lease is a short-term contract. At the end of the period, the asset concerned is returned to the lessor by the lessee. The leasing costs are charged to the profit and loss account for the appropriate period. A finance lease is a long-term contract. The value of the leased asset is shown or 'capitalised' in the lessee's balance sheet (unlike an operating lease). The commitment to the lessor is split between short and long-term liabilities. The asset concerned is depreciated each year by the amount of the capital repayments. Interest charges on the lease agreement are charged to the profit and loss account when they are incurred.
- **Liability Amounts -** monies owed by a business or company. Its usage varies: 'total liabilities' can mean equity plus amounts due to creditors. But, it may mean amounts owed to third parties or creditors only such as banks and suppliers.
- **LIFO (Last In First Out)** - a method of stock (Inventory) valuation which assumes that the last item delivered to stock is the first to be used. The cost charged in the Profit and Loss Account is, therefore, the most recent cost and, in times of inflation, will be higher than under FIFO (First In First Out). It is not accepted as a method by the HMRC in the UK but it is sometimes used in management accounts to maintain up-to-date costs.
- **Limited Company** - a company is a separate legal entity belonging to the Shareholders who own it. Limited means that the liability of the

Shareholders is limited to the amount they have invested in the company. A public limited company (legally abbreviated to plc or PLC) is a type of limited liability company in the United Kingdom (and other jurisdictions where company is law is derived from English law) which is permitted to offer its shares to the public and has a certain minimum issued share capital. A public limited company may not necessarily be a 'quoted' company (that is, a company whose shares are listed on a Stock Exchange). A 'quoted' company is also referred to as a 'listed' company. All other companies are 'private' companies.

- **Limited Liability Partnership (or LLP)** - a special type of company with limited liability protection but which is treated for tax purposes as if it were a partnership. It has "Members" rather than "Shareholders".
- **Liquid Assets or Liquid Resources** - the value at the balance sheet date of all assets that are either represented by cash or are transferable into cash at short notice.
- **Liquidity** - the extent to which a business has access to cash. Therefore, it is a measure of the ability of a business to meet its short-term commitments. If a company expands too quickly, capital expenditure, trade debtors and stocks may increase so fast that creditors cannot be paid promptly because cash flow is inadequate. This is called 'overtrading'.
- **Margin of Safety** - the difference in activity or output between a company's current level of activity or output and the level producing a break-even result. At break-even, a company's revenues are equal to its total costs.
- **Marginal Cost and Marginal Costing** - marginal cost is the extra or incremental cost of producing/selling an extra unit of output. Marginal costing is a system of costing used for decision-making purposes that focuses on the recovery of direct, incremental or variable costs only. The system should be used with caution.
- **Market Capitalisation** - the stock market value of a company calculated by multiplying the price per share by the number of issued shares.
- **Market To Book Ratio** - the market capitalisation divided by the book value of a company's equity in its balance sheet.
- **Minority Interest** - a non-controlling ownership of less than 50% of a company's voting shares by either an investor or another company.
- **Mortgage** - a form of long-term borrowing secured against a specific asset such as a building.
- **Net Assets** - this is total Assets (fixed and current) less Current Liabilities and long-term liabilities.
- **Net Current Assets** - this is current assets less current liabilities.
- **Net Present Cost** - the sum of the annual negative cash flows from operations for a project discounted at the cost of capital.
- **Net Present Value (NPV)** - the sum of all the annual negative and positive present values of future cash flows from operations. The present values are calculated by discounting the cash flows at the cost of capital. The NPV at the cost of capital is equivalent to the shareholder value created by the project.
- **Net Profit** - net profit normally means profit after deduction of all operating expenses, including both fixed costs and overheads as well as variable costs, depreciation and amortisation. It is normally the profit before deduction of tax, in which cased it is often referred to as 'net profit before tax' or PBT.
- **Net Realisable Value** - the value that could be obtained by disposing of assets. It is not normally used in financial statements, except in the valuation of stocks. If the realisable value is less than cost, then net realisable value should be the basis of stock valuation. In the UK, property companies revalue their property investments to market or realisable value.
- **Net Worth** - synonymous with net assets and equity.
- **Nominal Value** - the face value of a security. In the case of Share Capital it is also known as the Par Value, and may reflect the price at which shares were originally issued. However, a new share issued later may be issued at a price well above the nominal value (see Share Premium). The nominal value normally has no significance for the market value at which a share is traded.
- **Notes Payable** - the US term for short-term borrowings.
- **Off-Balance Sheet Financing** - potential liabilities which do not appear on the balance sheet of the company concerned. Examples include the borrowings of a Joint Venture and Associated Company.
- **Operating Costs 0r Operating Expenses**- all costs excluding the cost of sales, interest charges and taxation. Revenues less the cost of sales and operating costs equals operating or trading profit. The abbreviation, PBIT, (Profit Before Interest and Taxation) is the same as operating profit. Operating income, EBIT (earnings before interest

and tax) and trading profit are other terms used for operating profit.

- **Operating Margin** - see profit margin.
- **Operating Profit** - revenues less the cost of sales and operating costs. Other descriptions for operating profit are profit before interest and taxation (PBIT), earnings before interest and taxation (EBIT), operating income and trading profit.
- **Opportunity Cost** - the sacrifice involved in pursuing one course of action rather than another or making a particular decision rather than another. For example, if a new factory is built on land that could otherwise be sold and the factory is built then the opportunity cost is the potential sales proceeds from the land if it had been disposed of. This opportunity cost should be included in the financial evaluation of the new factory project.
- **Ordinary Shares** - these are the most common form of shares. Holders of these shares are the voting and risk bearing owners of the company. They receive dividends that vary in amount, being subject to the company's underlying profitability and the directors' recommendations. The US term for ordinary shares is common stock.
- **Over-Trading** - see Liquidity.
- **Overdraft** - money owed on a bank current account. A form of short-term borrowing. It is repayable on demand.
- **Par Value** - the face, or nominal, value attributed to each of the company's shares. This has no relationship to either the value of the company or to the quoted price.
- **Payback Period (strictly speaking: The Discounted Payback Period)** - the length of time before the present value of the cumulative cash flows from operations for an investment project reaches zero. This is equivalent to the length of time before a project recovers the present value of the initial cash outflows. It is the 'break-even' time and is a measure of capital efficiency and risk.
- **Preference Shares** - dividends on preference shares must be paid before Dividends are paid on Ordinary Shares hence the word 'preferred'. They are paid at a set percentage of the nominal or par value of the preferred share. For Cumulative Preference Shares, all past unpaid preference dividends must be paid before an ordinary share dividend is paid. Preference Shares are not part of a company's equity and, on a winding up of a company, are normally paid out before Ordinary Shares.
- **Prepayment** - a payment made during the current accounting period for a cost relevant to a later period. This means that the cost is charged as an expense in the future period's Profit and Loss Account even though the cash outflow takes place in the current period. Examples are insurance premiums and rent and business rates paid in advance.
- **Present Value** - the value today of cash receivable from operations at some time in the future. It is calculated by multiplying future cash flows from operations by discount factors which depend on when the cash flows are expected to be received.
- **Pre-tax profit** - the figure reported by the company in its Profit & Loss Account reflecting the results of all business activities and decisions for the financial period.
- **Price-Earnings Ratio (P/E Ratio)** - the market price of a share divided by the earnings per share to give the number of years' earnings per share represented by the current share price. It is a financial status symbol. The higher the P/E ratio, the more attractive a company's earnings prospects are perceived to be. The historic P/E ratio is based on the latest reported earnings per share. The forward or prospective P/E ratio is based on the forecast earnings per share.
- **Profit** - the difference between Revenues, Sales or turnover and the costs incurred for an accounting period. In view of the 'matching' principle, earning a 'profit' is not the same as generating cash since sales are recognised in the Profit and Loss Account, when goods or services are supplied (rather than when they are paid for by the customer). Costs are incurred during the time period to which they relate (which may not be when they are paid for in cash) and some costs, such as Depreciation or Amortisation, do not involve cash outlays at all. It is important to note that there are a number of different measures of profit.
- **Profit Before Taxation** - the profit after all costs, including financing costs or interest charges, but before taxation and dividends.
- **Profitability Index** - the net present value of future cash flows is divided by the present value of future cash outflows or cash outlays. It is a measure of capital efficiency which ranks projects according to the net present value they generate per £ of investment. The profitability index can also be defined as the present value of future cash inflows divided by the present value of future cash outflows. Project rankings are unchanged regardless of which definition is used. The profitability index is used when the

cash available for capital expenditure is limited. This situation is referred to as capital rationing.

- **Profit and Loss Account (P&L)** - a key reporting and measuring tool (along with the Balance Sheet and Cashflow or Cashflow 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).
- **Profit Margin** - a measure of the profitability of Sales. It is defined as the profit before or after interest and taxation expressed as a percentage of Sales. The operating or trading margin is the profit before interest and taxation expressed as a percentage of Sales. The net margin is the profit after taxation divided by Sales expressed as a percentage.
- **Pro-Forma Results** - financial results before taking into account unusual, exceptional or 'one-off' items such as acquisition and merger transactions, asset write-downs and rationalisation costs.
- **Provisions** - the amounts set aside in a Balance Sheet for prospective, future, liabilities that can not yet be fully quantified. Similar to Accruals and Accrued Charges. It is an additional allowance for a cost or charge incurred during a period but not paid by the end of period balance sheet date. Examples of provisions are the estimated cost of redundancies and the costs of reorganising a business. Provisions may be disclosed separately as exceptional items if they are significant. A provision is included as a cost in the Profit and Loss Account and as a liability in the Balance Sheet. A distinction is drawn sometimes between Accrued Charges (the precise amount is known) and a provision (an estimate).
- **Quick Ratio** - current assets, excluding stocks, as a multiple of current liabilities. It is a measure of the ability of a business to meet its short term commitments (within 12 months).
- **Realisable Asset Value** - the price at which an asset, a group of assets or a business could be sold.
- **Real Return** - the return earned by a business or project after allowing for inflation.
- **Receivables** - the same as Trade Debtors.
- **Replacement Cost or Current Cost** - assets may be valued at their replacement cost rather than their historic cost. This is sometimes done in management accounts so that a business is charged with current rather than historic levels of cost.
- **Replacement Cost Operating Profit** - the profit after allowing for the extra or reduced cost of replacing stocks and before interest and taxation. It is used, for example, by oil companies as an important measure of performance since their results are affected by the impact of changes in the input cost of crude oil.
- **Reserves**- the realised and unrealised gains which have added value to the business, and which form part of the equity. Realised gains produce profit. Unrealised gains arise from the revaluations of assets such as property. A third form of gain is the share premium paid over and above the nominal or par value of issued new shares.
- **Retained Profit or Retained Earnings** - the profit for the year after all charges and the distribution of dividends to shareholders. The figure for retained profit in the balance sheet will be the accumulated retained profit since the business started to trade. It may be shown as the revenue reserve, the profit and loss account reserve, retained earnings or retained profit.
- **Return on Capital Employed (ROCE)** - operating or trading profit (profit before interest and taxation) expressed as a percentage of capital employed. This is the pre-tax return on capital employed. A more rigorous measure is the 'after tax' ROCE - the profit before interest after tax expressed as a percentage of capital employed. ROCE is the most important measure of profitability. The ROCE measures the return earned by a business from its trading activities. This return is then compared with the return required by the shareholders and lenders financing the business. The return required by investors and lenders is called the cost of capital. For a business to create value the ROCE should exceed the cost of capital.
- **Return on Equity** - profit after taxation (earnings) divided by equity expressed as a percentage.
- **Return on Sales** - the operating **profit** divided by sales expressed as a percentage. It is also called the operating margin.
- **Revaluation Reserve** - the difference between the original cost of **an** asset, usually property, and its current market value. The difference is added to the original cost of the property and added to equity as a revaluation reserve.
- **Revenue** - see Sales.
- **Revenue Expenditure** - Expenditure charged to the Profit and Loss Account or income statement in the period in which it is incurred.

- **Revenue Reserve** - see Retained Profit.
- **Rights Issue** - the issue of additional shares by a company to its existing shareholders (in proportion to their existing holdings) normally at a discount to the prevailing stock market price in order to ensure a successful issue.
- **Sales** - the invoiced value of the goods and services provided to customers during an accounting period. It is also called revenue or turnover. It excludes VAT (or, in some jurisdictions, sales taxes).
- **Scrip Issue** - a free or bonus issues of new shares to existing shareholders in proportion to their current holding. No monies from the new Share Capital are received and no extra cash is raised. A company converts some or all of its retained profit into shares. Since the number of Ordinary Shares will increase, the share price will fall pro rata.
- **Secured Loan** - a loan against which a certain asset or assets is pledged. If the borrower with the loan falls into default, the lender will obtain the available proceeds from the sale of these assets before any payment to unsecured creditors such as suppliers.
- **Securitisation** - the placing of a collection of assets (such as a chain of pubs or a portfolio of mortgages) into a special purpose vehicle (SPV). The SPV then borrows against the security of its assets. The borrowings are repaid from the cash flows generated by the SPV. One of the aims of securitisation is to separate the creditworthiness of the SPV from the general credit standing of the company that set up the SPV.
- **Sensitivity Analysis** - a technique used in investment appraisal. It assesses the effects on the net present value, the internal rate of return, the discounted payback period and the profitability index of changes in the assumptions supporting the estimated future cash flows from operations. Sensitivity analysis asks the ‘what if’ question.
- **Share Buy-Backs** - the purchase of shares by a company from its own shareholders. It has the effect of reducing equity and increasing earnings per share and can boost the share price.
- **Share Capital** - the permanent capital contributed directly by the owners of a business (the shareholders) both at the start of trading and, subsequently, when additional capital is required to finance expansion. Issued share capital is the amount of capital contributed by shareholders and received by the company. Authorised share capital is the total amount of share capital which the directors are empowered to issue. Any premium on issue of shares above par value is shown as "Share Premium".
- **Share Dividend** - a Dividend paid in the form of an issue of extra shares rather than in cash.
- **Shareholders’ Interest or Shareholders’ Funds** - the sum of share capital plus retained profit plus other reserves at the balance sheet date. Synonymous with equity, net worth, net assets and share capital and reserves.
- **Share Premium** - the difference between the issue price and the nominal or par value of a share. When a premium is paid for new shares, a share premium reserve is created or increased.
- **Shareholder Return** - the total wealth returned to a shareholder by a company during a specific time period. It is calculated by adding together the appreciation (or fall) in the share price and the Dividend per share received and expressing the result as a percentage of the opening share price. For example; the share price was 100p at the start of a 12 month period and 110p at the end; the dividend per share received during the year was 5p. The total gain was, therefore, 110p less 100p plus 5p to give 15p. 15p expressed as a percentage of the opening share price (100p) is 15%. 15% is the annual rate of shareholder return. When shareholder return is calculated over a period of several years, it is assumed that dividends are reinvested to purchase additional shares.
- **Solvency** - the ability of a business to meet its longer-term commitments. See also Debt: Equity Ratio and Interest Cover.
- **Standard Costing** - a system of costing – predetermined costs are compared with actual costs to highlight differences or variances which are then investigated.
- **Stocks (or Inventory)** - the combined value of raw materials, work in progress or under construction, and finished goods held. They are normally valued at cost or net realisable value, whichever is lower. The US equivalent term for Stocks is Inventory.
- **Stock Turnover Rate** - the average number of times each year that stocks are ‘turned over’ or used in the course of trading activity. It is calculated by dividing the cost of sales by average or closing stocks. (When computing the ratio from published accounts, the cost of sales may not be known; in such cases, the sales figure is normally substituted).
- **Subsidiary Company** - a company

where more than 50% of the voting shares are owned by another company.

- **Sunk Cost** - a cost that has been incurred already, for example, market research and product development costs. Sunk costs should be excluded from future cash flows from operations since they are 'spilt milk' – they are past expenditures which exist regardless of future project decisions.
- **Trade Creditors** - amounts due to suppliers for goods and services received but not yet paid for. They are normally due for payment within 12 months of the balance sheet date, and are part of current liabilities. A capital creditor refers to unpaid amounts for capital rather than revenue expenditure, for example, unpaid bills for new plant and machinery. The American term for trade creditors is accounts payable.
- **Trade Debtors** - the amount due from customers in respect of goods and services supplied but not yet paid for. Usually reported under current assets, but a note may disclose that some trade debtors are not expected to pay **within** the coming year. The American term for trade debtors is accounts receivable.
- **Trading Or Operating Profit** - profit **before** interest and taxation (PBIT). It is also referred to as EBIT (earnings before interest and taxation) and operating income.
- **Trial Balance** - a list of debit and credit balances in individual accounts in the accounting records of a business from which a Profit and Loss Account and a Balance Sheet are prepared.
- **Turnover** - the sales, or gross revenue, of **the** company during the financial period.
- **UK GAAP** - UK General Accepted **Accounting** Principles being a widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board.
- **Value Added** - the difference **between** sales and the cost of bought-in materials and services. It is the wealth created by the activities of a business.
- **Variable Cost** - a cost which varies according to the volume of production: for example, raw material and packaging costs. Semi-variable costs are partly fixed and partly variable: for example, utility charges such as electricity and gas include a fixed charge plus a variable charge dependent on usage.
- **Variance** - the difference between a budgeted or standard figure and the actual result. There are a number of different kinds of variances including material price and usage variances; labour rate and efficiency variances; variable overhead rate and efficiency variances' fixed overhead spending, volume and efficiency variances.
- **Working Capital or Net Current Assets** - current assets (such as trade debtors, cash and stocks) less current liabilities (such as trade creditors, bank overdraft and accrued charges). Trading working capital is current assets excluding cash balances less current liabilities excluding short-term borrowings. Working capital is the net investment in short-term assets giving a company the resources it needs to trade on a day-to-day basis. It is likely to fluctuate according to the needs of the business, for example, seasonal requirements.
- **Zero Based Budget** - a budget compiled without reference to the previous year's budget. It challenges the status quo.

# Further Information

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