

Understanding
Financial Terms



*Definitions
in plain English*



Cash flow, debit card, mutual fund, bonds, price earnings, basis, fair market value and capital gains are common financial terms. But what do all these terms mean? The road to understanding accounting, tax, banking and investment terms is often more complex than necessary. Use this as a helpful guide to understand some of the basic terms and what they mean. The terms are divided into three sections:

- **Accounting Terms**
- **Tax Terms**
- **Banking & Investment Terms**

ACCOUNTING TERMS

■ **ASSETS:** Refers to what you own that has lasting value. Common assets are cash, inventory, furniture, autos, accounts receivable, investments and the like.


■ **BALANCE SHEET:** Represents the historic health of a business over time. It is a snap shot of the business “as of” the date it is run. It contains all the things of value (Assets), keeps track of all that is owed (Liabilities), what was invested by owners (Shareholder Equity), and what earnings are retained. The basic calculation is:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

■ **CASH FLOW:** Assessing what is received in cash minus what is paid out. The more cash coming in versus going out, the better your cash flow.

■ **DEBITS AND CREDITS:** The core building blocks for all accounting. The accounting system is a double entry bookkeeping system developed by Luca Pacioli, an Italian Monk, in 1494. Accounting is based upon two entries for every action. The left side of the entry is called a Debit, the right side of the entry is called a Credit. They must always be in balance. For example, if you spend \$50 for groceries and pay cash the entry would look like this:

	<u>Debit</u>	<u>Credit</u>
Groceries	\$50.00	
Cash		\$50.00



■ **EQUITY:** The net worth of a company calculated by taking Assets minus Liabilities. When you own stock in a company your shares represent part of that company's Equity.

■ **INCOME STATEMENT (P & L):** A periodic statement that tells how well a company performed during a specific time period. It is calculated by taking Sales and subtracting Expenses and Costs. The result is income if there are more sales than expenses/costs. The resulting income is then transferred to the Balance Sheet within the Equity section. The basic calculation is:

$$\text{Income} = \text{Sales} - (\text{Cost of Product} + \text{Expenses})$$

■ **LIABILITIES:** What you owe others. Common liabilities are credit card debt, loans, accounts payable and mortgages. It is reported on the balance sheet.

■ **NET WORTH (ALSO SEE EQUITY):** The value of what you would have if you sold all your assets and paid all your liabilities. It is what you're worth.


TAX TERMS

■ **ADJUSTED GROSS INCOME (AGI):** A core tax term, AGI refers to your Gross Income (Wages, Interest, Dividends, Gains, etc.) minus adjustments (IRA deductions, 1/2 of self-employment tax, alimony paid, savings withdrawal penalties, qualified student interest, moving expenses and a few other deductions).

■ **ALTERNATIVE MINIMUM TAX (AMT):** A creation of the tax code, the AMT refers to a minimum tax that everyone must pay. It was introduced to target those folks with high incomes who were clever enough to avoid paying any tax. Today a surprising percentage of Americans are being impacted by the AMT.

■ **BASIS:** A tax term that refers to the value of what you have invested within a capital asset. For example, it is the value you have invested in your house, including improvements.

■ **CAPITAL GAINS:** When you sell an item of value like your home you often do not receive exactly what you paid for it. The difference results in a gain or a loss. These gains/losses are called capital gains or losses.



■ **FAIR MARKET VALUE (FMV):** What something is worth in today's market place. It generally is a dollar amount at which a seller will sell their property and a buyer will buy the property at a given time.

■ **1099s AND W-2s:** The basic forms for reporting income and revenue. W-2s are issued by employers to their employees to report wages and withholdings. 1099s are issued to anyone who receives income that is not employee wages or salary. Common 1099 issuers are banks (for interest payments), businesses (to consultants), Investment firms (for interest and dividend payments). The forms are also sent to the IRS, who then cross checks returns to make sure all income is being reported.

BANKING & INVESTMENT TERMS

■ **ANNUITIES:** A contract with an insurance company by which you provide money to the company and they agree to pay you income with an established rate of return over a period of time.

■ **AUTOMATIC TELLER MACHINE (ATM):** A cash machine that allows withdrawals or deposits without spending time at the teller window within the bank.

■ **BONDS:** Simply put, bonds are loans. These “loans” are normally for businesses (Corporate Bonds), Government (Treasury Bonds), or local communities (Municipal bonds). Like other loans, the bonds pay interest. There is also a secondary market for buying and selling bonds to other parties. This market allows bonds to be sold at a premium or discount depending on the prevailing interest rate at the time. Like loans, bonds also have varied levels of risk. The riskiest bonds are called “Junk” bonds. You receive high interest, but there is a risk you will not be paid back for your “loan.”

■ **BOOK VALUE:** What would be left on a company's financial statements if they cashed out – basically, Assets minus Liabilities. “Adjusted Book Value” takes the assets and liabilities on the financial statements and “adjusts” their value to the fair market value.

Banking & Investment Terms continued

■ **CERTIFICATE OF DEPOSIT (CD):** A bank product that pays you a set amount of interest if you agree to let the bank have your money for a set amount of time. The time period may be as short as 30 days up to as long as 10 years. There is a large penalty if you request your money prior to the payment date of the CD.

■ **CURRENT RATIO:** Current Assets divided by Current Liabilities on a company balance sheet. It is a measure of how much would be available if a company had to pay all their immediate debts with readily available funds. A Current Ratio less than 1 spells trouble, with insolvency looming.

■ **DDA:** A bank term that refers to checking accounts. It stands for Demand Deposit Account.

■ **DEBIT CARD:** A plastic card that acts like a paper check, but looks like a credit card. The difference is that funds are pulled directly from your checking account. Whereas a credit card acts like a loan that you pay back, a debit card requires that you have money in your checking account.

■ **DEBT TO EQUITY:** A bank calculation also known as “leverage” that determines how much of your assets are owned by you and how much is owned by others via loans. The greater your Debt to Equity ratio, the less likely you will get additional financing.

■ **ELECTRONIC DATA INTERCHANGE (EDI):** The act of transferring financial transactions electronically. It is a method of paying bills or receiving deposits without paper.

■ **ESCHEAT:** The process by which banks and financial institutions give unclaimed deposits to the state. If the bank cannot find the person who deposited the funds, they must by law turn those funds over to the state.

■ **INTEREST COVERAGE:** Refers to how much is available to pay interest on a loan. Banks like to see ample available cash to make loan and interest payments. For a

business the coverage should be over 2 times the interest payment. For consumers, banks do not like to see loan payments over 1/3 of total household income.

■ **LOAN TO VALUE (LTV):** A bank term that refers to how much money they will lend to you against a secured asset such as your home. An 80% LTV means the bank will loan you up to 80% of the market value of your asset (i.e. home).

■ **MUTUAL FUNDS:** A collection of stocks purchased and managed for a group of investors. Mutual funds were developed to allow individual investors the ability to spread their risk among a number of different stocks without a huge investment. Professional fund managers stay on top of the portfolio and buy or sell stocks to obtain the best return per published objectives.

■ **OPTIONS:** A term that allows you the right to buy or sell property (usually stock or commodities) at a set price within an established period of time. Options are popular with speculators because they do not have to have 100% of the purchase price at the time the option is placed.

■ **PRICE EARNINGS RATIO (PE RATIO):** A measure of a company's stock price relative to a company's earnings. The higher the ratio, the more expensive the stock is relative to company earnings.

■ **PRIME RATE:** An established interest rate that banks use as a benchmark loan rate available to their best customers.

■ **REAL ESTATE INVESTMENT TRUST ACCOUNT (REITA):** An account that invests funds in Real Estate. This Real Estate is then rented out or leased. The income received increases the value of the funds. Earnings are also captured when property is sold for a profit. This is a popular investment alternative to stocks and bonds.

■ **WORKING CAPITAL:** Current Assets minus Current Liabilities. In real terms, the amount of money (capital) that would be available if a company had to pay all their bills due within 12 months with liquid funds.

This publication provides only summary information regarding the subject matter. Please call with any questions on how this information may impact your situation.