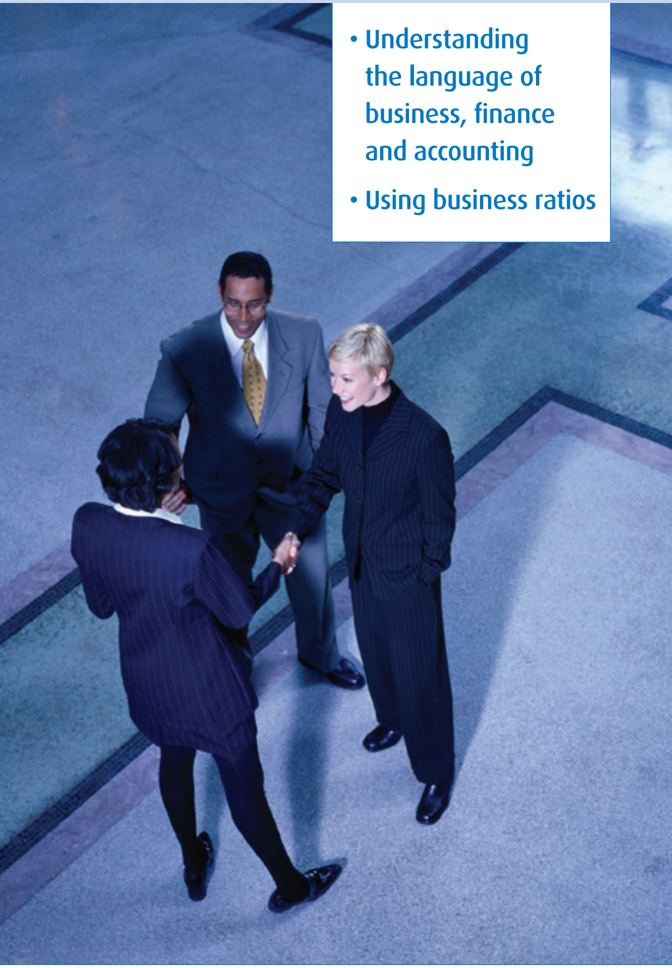
Making sense of financial terms and jargon

BUSINESS COACH SERIES

- Understanding the language of business, finance and accounting
- Using business ratios



BMO Bank of Montreal®

Initiation into the language of business

The situation

For those unfamiliar with financial terms and jargon, the language of business can seem mysterious or foreign. As a businessperson, it can be embarrassing and a detriment to be placed in an environment — such as a loan office or a meeting with business associates — where terminology that you don't recognize is commonly used and taken for granted.

The solution

At BMO Bank of Montreal®, we are committed to helping Canadian business develop and succeed. The purpose of this Business Coach is to help you to better understand bankers, accountants, lawyers and other specialists, and "talk the talk" of business.

Every profession and business field develops its own terms and jargon. Such terminology helps convey ideas and concepts quickly, which simplifies communication for insiders but makes things appear more complex for the uninitiated. This Business Coach highlights:

- Most of today's commonly used terms in an easy-to-find glossary format.
- Business ratios explained with examples. Ratios are useful in determining whether your business is doing better or worse than the industry average or a competitor. They can be essential in comparing your company's performance from year to year, and can often provide a rule of thumb to guide the operation of your business. Industry ratios can be obtained from such sources as Dun and Bradstreet's Key Business Ratios in Canada, industry association statistics, trade magazines, bankers and accountants.

Due to space limitations, this list is far from complete. If precise legal interpretation is required, you should refer such enquiries to competent legal counsel.

Finally, if you are confronted in a discussion with a term you do not understand, it is better to ask for an explanation than accept something that could come back to haunt you later.

Useful definitions, terms and ratios

- **Accrual accounting.** This is the standard form of accounting where transactions are recorded as they occur (e.g., sales when they are invoiced). It does not take into account when the cash is paid out or received. When cash transactions are recorded, it is called accounting on the "Cash" basis, which is rare for businesses. The accrual method gives you an accurate snapshot in time but does not help in monitoring the all-important cash flow.
- **Acid test (quick ratio)**. Current cash and "near" cash assets (e.g., government bonds, current receivables, but excluding inventory) compared to current debts (bank loans, payables).

  The acid test shows how much and how quickly cash can be found if a company gets into trouble.
- **Accountant's review.** When financial statements have been prepared without audit but have been reviewed by a firm of professional accountants, a "Review Engagement Report" is attached. This states that the review "consisted primarily of enquiry, analytical procedures and discussion" of the figures and "does not constitute an audit" or result in an audit opinion. Outsiders, such as bankers or investors, usually do not place full confidence in such figures. (See "Audited financial statements.")
- **Aging.** Measuring the length of time an account (e.g., a payable or receivable), has been outstanding by the number of days. These are commonly grouped into 30, 60 and 90 days and over, etc. Not only can these be compared to the original terms, but also they show

quickly whether the situation is improving or deteriorating. Receivables and payables can be expressed as the average number of days outstanding.

- **Arm's length.** Refers to a transaction between two or more unrelated companies or individuals.
- **Audited financial statements** are required to follow accounting and auditing standards as outlined in the Canadian Institute of Chartered Accountants (CICA) Handbook. The company's management is responsible for preparing the financial statements.

  The auditors are responsible for testing the amounts and disclosures and assessing accounting principles used and significant estimates made by management. The auditor's report concludes whether, in their opinion, the financial statements present fairly, in all material respects, the balance sheet and the results for the year.

  The standard audit report has only three paragraphs. If there is an additional paragraph, you should fully understand the reason for the variation. It will almost certainly be queried by any financial institution. Also, study the "Notes" to the statement carefully, particularly those, if any, referred to in the audit report. Important issues, such as concerns of the viability of the corporation on a "going concern" basis, may only be referred to in the "Notes".

  An audit report attached to financial statements gives much weight and credibility when dealing with outsiders such as bankers and investors or when you are buying or selling a company.

- **Balance sheet.** An itemized financial statement listing all major assets and liabilities of a company at a certain point in time. The name comes from the fact that the two columns are "balanced," the net difference being the capital paid in plus or minus the retained earnings or losses to date, which is referred to as shareholders' "equity".
- **Balance of sale.** (Also known as a Vendor Take Back). An expression used when the seller of a company takes back a portion of the selling price in a note, debenture, or mortgage (see "debenture").
- **Board of directors.** Representatives elected by the shareholders to direct the affairs of a company. In small private companies, an often overlooked source of good business judgement and experience.
- **Book debts.** A banking term for trade debts or receivables. Frequently "assigned" to the bank as security for an operating line of credit.
- **Book value.** Used interchangeably with "net worth" and means the net difference between the total assets and total liabilities of a company, which in fact equals the capital stock plus or minus the retained earnings of the company.
- **Bottom line.** A colloquial expression most frequently referring to the profit (earnings) of a company — that is, to the bottom line in the profit and loss statement. In smaller businesses, it frequently refers to "Profit Before Tax".
- **Breakeven.** The point at which sales less cost of goods (i.e., gross profit) equals overheads; the level of sales required to produce zero level of profit.

- **Break-up value.** The estimated value of a business after its operations are stopped, the assets are sold and the liabilities are paid off. Usually less than the "going concern" value.
- **Bridging/bridge loan.** A short-term loan to cover the purchase or construction of an asset until permanent financing, frequently a previously arranged mortgage loan, can be drawn down against the completed asset.
- **Budget.** A financial plan showing projected revenues and expenses over a specified period. Should be used for control purposes.
- **Buy-sell.** A legal agreement between two or more shareholders setting out the conditions under which each may sell their shares. Such agreements may include "shotgun," "piggyback," right of "first refusal" or similar clauses. Partners and shareholders in smaller businesses frequently overlook the need for such agreements.
- **Business interruption insurance.** A type of insurance available to cover lost income in the event of the complete or partial shutdown of a business from specified causes (e.g., fire, evacuation, etc.).

- **Cash flow.** The timing of the flow of cash in and out of a company, usually projected by month to show the net cash requirement needed during each period. This is an extremely important financial tool for the owner/manager. (See the companion Business Coach booklet *Planning Your Cash Flow* on this topic).

  Cash flow can also refer to the profit of a company before deductions of non-cash items such as depreciation and before deductions for tax.
- **Chattel mortgage.** A charge over goods or equipment of a movable nature, as opposed to real estate.
- **Collection period.** The average number of days it takes a company to collect receivables. (See also "aging.")
- **Collateral.** An asset/security which is pledged to support/secure a loan — e.g., a collateral mortgage on a house, or a pledge of a bond, taken as security by a bank to support a term or operating loan.
- **Contribution.** In accounting terms, means the amount "contributed" to overhead by a given product or activity, after deduction of all direct costs associated with the production of that product.
- **Coverage.** Ratios used to test the adequacy of cash flows generated through earnings for purposes of meeting debt and lease obligations, e.g., 2 to 1 debt coverage means there are $2 of assets to $1 of debt. This could also be referred to as 200% coverage or 100% margin.
- **Current assets.** Those assets or properties of a company which are expected to be turned into cash within a year.

- **Current liabilities.** Those debts or liabilities of a company which are due within a year.
- **Current ratio.** Current assets compared to current liabilities. Used as an indication of liquidity.

  It is a measure of the cash or near cash available for the running of a business (see also "working capital"). It also indicates whether, in a crunch, a business could meet its current obligations or debts.
- **Daylight loan.** A loan that exists for less than one working day. Such loans are often used to complete a series of legal transactions which must take place consecutively.
- **Debenture.** A formal written obligation of a company to pay a specified amount on a certain date(s). They are normally registered and are frequently secured by one or more assets, but not usually in first position. (See "Fixed charge/ floating charge.")

  A debenture usually contains negative covenants (what you may not do — e.g., allow your current ratio to fall below 1:1) and positive covenants (what you must do, such as pay interest when due). Failure to meet a covenant gives the debenture holder the right to certain remedies (e.g., call the loan, put in a receiver, etc.).
- **Deemed realization.** A transfer of assets which is considered "a sale" by Revenue Canada though no cash or other consideration may be involved.
- **Double indemnity.** A type of insurance that pays double the principal amount if loss occurs due to certain specified causes (e.g., accidental death).

- **Earnings per share (EPS).** The earnings of a company divided by the number of common shares outstanding. In public companies, EPS is usually expressed "after tax"; in smaller private companies it is usually "pre-tax."
- **Equity.** The difference between the assets and liabilities of a company, often referred to as "net worth". The equity is the property of the shareholders (also referred to as "equity holders").
- **FIFO (first in, first out).** A method of valuing inventory where the merchandise acquired earliest is assumed to be used first, and the stock acquired more recently is assumed to be still on hand in inventory. (See also "LIFO").
- **First refusal.** The right of a second party to buy shares or property on the same terms and conditions as have been offered to a first party. The right usually has a short time period attached to it, say 10 to 30 days.
- **Fixed costs**. Those costs a firm incurs regardless of level of production or business activity.
- **Fixed charge/floating charge.** A "fixed" charge is a claim registered against a specific asset(s). A "floating" charge is registered against all assets (unspecified) and ranks in priority behind "fixed" charges. A "first fixed and floating charge" debenture would list a first charge against certain assets and floating charge against all others.
- **FOB (free on board).** A term frequently used to indicate the point at which goods are available at a specified price, and from which point all transportation, insurance and other charges will be to the customer's account.

- **Future contracts (foreign exchange forward contracts).** A commitment with a bank by a businessperson to purchase or to sell a foreign currency at a specified future date at a fixed price. Future contracts are largely for importers and exporters buying and selling goods for future shipment whom wish to establish in advance their costs or prices.
- **Goodwill.** Theoretically, the value of customer lists, trade reputation, etc., which is assumed to go with a company and its name, particularly when trying to arrive at the sale price for a company. In accounting terms, it is the amount a purchaser pays over the book value.
- **Gross margin/profit.** Profit after deduction of all costs of material, labor and factory overhead, but before selling and administrative costs. “Gross margin” is “gross profit” expressed as a percentage of sales.

- **Hot buttons.** Key operational information which can give an early indication of the health of a company. These frequently include receivables and payables expressed in days, inventory level and turnover, warranty claims and level of returned goods, order book, and back order levels. You should know and watch the "hot buttons" in your company.
- **Income-splitting.** A tax planning device frequently available to business owners where total tax paid by the company and the shareholders can be minimized. "Splitting" can refer to splitting between salaries and dividends, husband and wife salaries, etc.
- **Inventory turnover.** The number of times the value of inventory cost (based on either an average level or at year end) divides into the cost of goods sold in a year. It can also be expressed as a number of days.

  Both are a measure of your efficiency in the use of one of your major current assets — the higher the turnover, the more efficient — provided you are not in danger of running out of stock.
- **Key-person insurance.** Special insurance available on the lives of the principal active shareholders in a company. Can be used to fund buy-sell agreements, as well as to provide funds to continue the company in the event of one manager's death. The name the policies are registered in, as well as who pays the premiums, can have important tax implications.
- **Letter of credit.** A written undertaking, usually by a bank (the issuer), given to the seller (the beneficiary) at the request of and in accordance with the instructions of the buyer (applicant) to effect payment up to a stated sum of money, within a prescribed time limit and

against stipulated documents. It is commonly used in foreign transactions. Remember that the extent to which the letter of credit is used will frequently reduce the availability of other credit from the bank, as the bank is guaranteeing your payment.

- **Leverage.** The ratio by which debt exceeds equity. A healthy ratio is usually not more than 2:1 or 3:1. A leverage ratio that is too high can make a company highly vulnerable in times of economic downturn or reduced profit.
- **Leveraged buyout.** To complete the financing in the purchase of a company, the purchaser borrows against the company's unused borrowing capacity (usually based on the market value of the company's assets rather than the book value).
- **Lien.** A charge placed over an asset by such parties as (1) the seller of that asset or (2), in the case of construction or repairs, the person (contractor) who carries out the work. The lien-holder may take possession until the asset/work is paid for in full. Liens must be registered under the various provincial laws in order to be protected and enforceable.
- **LIFO (last in, first out.)** A method of valuing inventory, where the merchandise acquired latest is assumed to be used immediately and what was acquired earliest is assumed still to be in inventory. LIFO attempts to match the current cost of materials against current sales. Compared to FIFO (see separate definition), the LIFO method usually results in the reporting of less income when prices are rising, and more income when prices are falling. Under LIFO, current purchase prices immediately affect operating results. It allows adjustment of selling prices to reflect current costs and therefore the maintenance of gross margins.

- **Limited liability.** The legal protection accorded shareholders of an incorporated company. Other than in cases of fraud, the owner's financial liability is limited to the amount of share ownership, except where he or she owes money to the company or has assumed additional liabilities (e.g., personally guaranteeing its debts).
- **Line of credit.** A negotiated agreement, subject to periodic review, between a borrower and the bank, whereby the borrower is permitted to draw down funds up to a specified limit on condition that certain stipulated requirements are met.

  A "revolving" line of credit means that the proceeds of the draw downs are usually for general operating purposes, with outstanding advances fluctuating within a stated maximum limit. A "non-revolving" line of credit is established for a one-time specific purpose, with the related advance carried on a strictly reducing basis.
- **Liquidity.** The ability to turn assets into cash. A frequent measurement of liquidity is the quick ratio or acid test — i.e., current near-cash assets over current liabilities. (See "acid test.")
- **Loan agreement.** Contract between the bank and the borrower in which the terms and conditions of a credit commitment are recorded.
- **Negative covenant.** An undertaking to not do certain things. It is frequently argued that negative covenants are preferable to positive covenants because it is easier to establish if something which was not to have been done has in fact been done — say in a debenture, usually constituting a default, which in turn gives rise to certain specified remedies which

can be taken by the debenture or other security holder. (See "debenture.")

- **Net lease.** A lease where a lessee/tenant is responsible for all costs related to the asset being leased; usually includes taxes, heat, light, power, insurance, and maintenance.
- **Net worth.** See "book value".
- **Overtrading.** Every company requires capital to finance its day-to-day activities. Higher sales usually require increased inventory, receivables, payables, salaries, rents, etc., to be financed in the normal business cycle. If a company operates comfortably with a working capital of $100,000 and sales of $500,000 (a 5:1 sales to working capital ratio) and expands its sales to $1,500,000, with the same working capital, its ratio has risen to 15:1 and in all likelihood the company will start feeling the pinch. It is also doing what is known as "overtrading." Any slowdown in receivables will cause an immediate cash shortage to meet maturing payables. In fact, overtrading can bankrupt an otherwise profitable company and should be avoided by proper financial planning. (See the companion Business Coach booklet *Planning Your Cash Flow* on this topic).

  While increased volume may result in more efficient use of capital, equipment and human resources, the sales-to-working-capital ratio will not improve radically overnight. Ratios vary for different industries, but 10:1 is usually a maximum. Check the figures in your own industry.
- **Pari passu.** Means side-by-side at an equal rate or in equal installments or, in terms of security, "ranking equally."

- **Partnership.** Non-incorporated business venture of two or more individuals or companies. Profits or losses flow, directly and equally, to the partners.
- **Par value.** The stated face value of a share shown on the certificate, a practice which is no longer permitted by modern corporate statutes. It rarely has any relationship to the traded or book value of the stock. Non-par-value stock (n.p.v.) is stock for which there is no stated face value.
- **Payables.** Trade or liabilities evidenced by an invoice or other form of documentation.

- **Payback.** Usually, the period of time required to pay back an investment in an asset from the income generated from that asset, after deduction of all related expenses including interest charges.
- **Piggyback.** A clause which allows a party the same rights as another if the other takes certain actions. A piggyback buy-sell would mean that if A sold shares, B would have the right either to force sales of his or her own shares at the same price (piggyback) or buy A's shares at the same price (right of first refusal), as well as the alternative of doing nothing.
- **Private placement.** A sale of block(s) of securities to a small group of sophisticated investors, such as life insurance companies, trust companies, pension funds, and venture capital companies. Rarely involves amounts of less than $500,000.

- **Profit and Loss Statement.** A financial statement which shows the revenue and expenses of an operation over a given period of time. Revenue less costs of goods is the "gross" profit. From this are deducted itemized selling and administrative costs, to give a "profit before taxes". What is left after deduction of taxes is "net" profit.
- **Proprietorship** (proper title "sole proprietorship"). An unincorporated operation. All income and expenses are treated for tax purposes as those of the individual proprietor. The owner does not enjoy legal protection of "limited liability" afforded by incorporation.
- **Receivables.** Money owing as evidenced by invoices issued for goods or services supplied, or other monies owed and evidenced by appropriate documentation.
- **Recourse.** In the event of default, gives the right to take possession of the asset.
- **Retained earnings.** The accumulated earnings after taxes. Retained earnings can in fact be negative, if a company has net accumulated losses.
- **Return.** The percentage yield on a given figure, usually some form of investment, as in:
  - Return on equity: earnings percentaged to the equity or book value of a company
  - Return on assets: earnings percentaged to the total assets.
  - Return on sales: earnings percentaged to current year's sales.

  It is important to note whether returns are before or after tax for comparison purposes.

  A return allows an investor to determine whether or not he or she is investing capital wisely. Return on equity can be compared to other forms of investment, (e.g., government bonds, real estate, or bank deposits). The same with return on assets.

Remember to make an allowance for risk — the higher the risk, the higher the return you should expect.

Return on sales is best compared to similar company and industry performance, as well as figures from a year ago and budgets.

- **Save harmless.** Also called an indemnity clause, whereby one party to a transaction tries to protect itself from a past or subsequent liability caused, usually unwittingly, by the other party. For example, in the sale of a company the vendor might be required to save the purchaser harmless from a third party suit trying to set aside the deal from undisclosed tax liabilities.
- **Shares (stock) — common.** The holders of common shares participate in the risks and rewards of a company. They usually have one vote per share and theoretically have a say in the management of the company — they elect the directors, who in turn appoint the management.
- **Shares — preferred.** Have some of the features of both debt and common stock. They rank ahead of common in the event of liquidation, but after other creditors. Usually preferred stock has a par value (p.v.) and the shareholder's claim is limited to that amount. Preferreds state a dividend, but payment is discretionary. The return is usually limited to the specified dividend.

- **Shotgun.** A clause in a buy-sell agreement whereby, if one party offers to buy out the other at a certain price, the other party has, within a limited period, either to accept the price or buy the offerer out at the same price.
- **Spread.** Expression used among financial sources to describe the difference between the interest rate they pay on money and the interest rate they charge.
- **Subordinated debt.** Where one lender has agreed in writing to rank behind another in claiming against an asset, that lender will receive capital back only after the other has been fully paid out. A bank will often insist that shareholder loans be subordinated to the obligations to the bank.
- **Tangible assets.** Those assets on the balance sheet which are represented by physical assets. They exclude "goodwill," prepaids, etc.
- **Temporary line of credit.** A temporary (say, two- or three-month) additional line of credit from a bank to cover a special or seasonal requirement. Sometimes called a bulge.
- **Tender credit.** A line of credit relating to certified cheques which accompany tenders submitted by a contractor.
- **Term debt/loan.** Technically, means any debt where repayment is scheduled beyond one year.
- **Variable costs.** Those costs which vary directly with the level of production or business activity (as opposed to "fixed costs," which do not vary).
- **Working capital.** In the technical sense, current assets minus current liabilities. In a more general sense, the amount of funds required to finance day-to-day operations.

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For more information on how BMO Bank of Montreal can help your business:

- talk to your Commercial Account Manager
- call us directly at **1-877-262-5907** or
- log on to **bmo.com/business-resources**

This document is designed for information purposes and should not be considered advice. For specific information on your business needs please consult with the appropriate business professional.

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