MODULE 3 - Bookkeeping/Accounting

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3.1 Terminology

As a new business you may not have had a deep involvement in some aspects of business, such as office administration, management, accounting, or government regulations. It is important to know some more commonly used terms and have some knowledge to being able to make sense of statements that the government, banks, bookkeepers, lawyers, clients, or accountants will send you.

Continual learning is important as this Module won't cover every aspect of the business world. The more you know about business in general and the more comfortable you are with using terms that are commonly used, the better your decisions will be because you will be focussing on the task or issue, not the vocabulary.

The following list is not a complete list, but it will cover some of the basic terms to get started. Everyone's current level of knowledge will vary, but if you know a term already, re-read the definition as you may have a slight variance in what you thought a term meant or how it is applied.

Note: Some terms (such as CPP and 401K) do not apply in every country. Canada and the USA have mostly all similar terms, but some will be either non applicable or a slightly different wording based on founding outlines. Make sure to search or find supplemental reading for terms as this is not an inclusive list and you will continue to learn over your course of time in the business world.

Definitions

Accounting (ACCG): A systematic way of recording and reporting financial transactions for a business or organization.

Accounts Payable (AP): The amount of money a company owes creditors (suppliers, etc.) in return for goods and/or services they have delivered.

Accounts Receivable (AR): The amount of money owed by customers or clients to a business after goods or services have been delivered and/or used.

Assets (Fixed & Current): Current assets (CA) are those that will be converted to cash within one year. Typically, this could be cash, inventory or accounts receivable. Fixed assets (FA) are long-term and will likely provide benefits to a company for more than one year, such as real estate, land or major machinery.

Asset Class: An asset class is a group of securities that behaves similarly in the marketplace. The three main asset classes are equities or stocks, fixed income or bonds, and cash equivalents or money market instruments.
Balance Sheet (BS): A balance sheet is a financial statement that reports a company's assets, liabilities and shareholders' equity. It is one of the three (income statement and statement of cash flows being the other two) core financial statements used to evaluate a business. The balance sheet is a snapshot, representing the state of a company's finances (what it owns and owes) as of the date of publication. Fundamental analysts use balance sheets, in conjunction with other financial statements, to calculate financial ratios.

Bonds & Coupons (B&C): A bond is a form of debt investment and is considered a fixed income security. An investor, whether an individual, company, municipality or government, loans money to an entity with the promise of receiving their money back plus interest. The “coupon” is the annual interest rate paid on a bond.

B2B/B2C: Is the purpose of your business to supply goods or services to other business? If so, you operate a B2B, or business-to-business, venture. On the flip side of B2B businesses are B2C businesses. These businesses supply goods or services directly to an end user or consumer.

Cash Flow: Cash flow is the movement of money in and out of your business. You want there to be a higher flow of income into the business than there is an outflow of expenses from the business. This is called positive cash flow.

Canadian Pension Plan (CPP): (CAN) The Canadian social security citizen, providing older or disabled citizens a basic level of lifetime income after age 65. Like the U.S. social security system, the CPP requires mandatory pay-as-you-go contributions by all workers, including self-employed individuals. Benefits will only be distributed to those who are eligible, who apply, and whose applications are approved by the government.

401k & Roth 401k: A 401K is a savings vehicle that allows an employee to defer some of their compensation into an investment-based retirement account. The deferred money is usually not subject to tax until it is withdrawn; however, an employee with a Roth 401K can make contributions after taxes. Additionally, some employers choose to match the contributions made by their employees up to a certain percentage.

Capital (CAP): A financial asset or the value of a financial asset, such as cash or goods. Working capital is calculated by taking your current assets subtracted from current liabilities—basically the money or assets an organization can put to work.

Cash Flow (CF): The revenue or expense expected to be generated through business activities (sales, manufacturing, etc.) over a period of time.

Certified Public Accountant (CPA): A designation given to an accountant who has passed a standardized CPA exam and met government-mandated work experience and educational requirements to become a CPA.

Cost Of Goods Sold (COGS): The direct expenses related to producing the goods sold by a business. The formula for calculating this will depend on what is being produced, but as an example this may include the cost of the raw materials (parts) and the amount of employee labor used in production.

Credit (CR): An accounting entry that may either decrease assets or increase liabilities and equity on the company's balance sheet, depending on the transaction. When using the double-entry accounting method there will be two recorded entries for every transaction: A credit and a debit.
A credit is an increase in a liability or equity account, or a decrease in an asset or expense account.

Debit (DR): An accounting entry where there is either an increase in assets or a decrease in liabilities on a company's balance sheet.

Depreciation (Dep): Depreciation is the term that accounts for the loss of value in an asset over time. Generally, an asset has to have substantial value in order to warrant depreciating it. Common assets to be depreciated are automobiles and equipment. Depreciation appears on the Income Statement as an expense and is often categorized as a "Non-Cash Expense" since it doesn't have a direct impact on a company's cash position.

Diversification: Diversification is a method of reducing risk. The goal is to allocate capital across a multitude of assets so that the performance of any one asset doesn't dictate the performance of the total.

Enrolled Agent (EA): (USA) A tax professional who represents taxpayers in matters where they are dealing with the Internal Revenue Service (IRS).

Equity and owner's equity (OE): In the most general sense, equity is assets minus liabilities. An owner's equity is typically explained in terms of the percentage of stock a person has ownership interest in the company. The owners of the stock are known as shareholders.

Expense (Cost): An Expense is any cost incurred by the business.

Expenses (FE, VE, AE, OE): The fixed, variable, accrued or day-to-day costs that a business may incur through its operations.

Fixed expenses (FE): payments like rent that will happen in a regularly scheduled cadence.
Variable expenses (VE): expenses, like labour costs, that may change in a given time period.
Accrued expense (AE): an incurred expense that hasn't been paid yet.
Operation expenses (OE): business expenditures not directly associated with the production of goods or services—for example, advertising costs, property taxes, or insurance expenditures.

Fixed Cost (FC): A Fixed Cost is one that does not change with the volume of sales. For example, rent and salaries won't change if a company sells more. The opposite of a Fixed Cost is a Variable Cost.

Generally Accepted Accounting Principles (GAAP): These are the rules that all accountants abide by when performing the act of accounting. These general rules were established so that it is easier to compare 'apples to apples' when looking at business financial reports.

General Ledger (GL): The complete record of a company's financial transactions over the life a company. The GL is used in order to prepare all of the Financial Statements.

Gross Margin (GM): Gross Margin is a percentage calculated by taking Gross Profit and dividing by Revenue for the same period. It represents the profitability of a company after deducting the Cost of Goods Sold.

Gross Profit (GP): Gross Profit indicates the profitability of a company in dollars, without taking overhead expenses into account. It is calculated by subtracting the Cost of Goods Sold from Revenue for the same period.

Income Statement (Profit and Loss) (IS or P&L): The Income Statement (often referred to as a **Profit & Loss**, or **P&L**) is the financial statement that shows the revenues, expenses, and profits over a given time period. Revenue earned is shown at the top of the report and various costs (expenses) are subtracted from it until all costs are accounted for; the result being Net Income.

I**ndividual Retirement Account (IRA)**: IRAs are savings vehicles for retirement. A traditional IRA allows individuals to direct pre-tax dollars toward investments that can grow tax-deferred, meaning no capital gains or dividend income is taxed until it is withdrawn, and, in most cases, it's tax deductible. Roth IRAs are not tax-deductible; however, eligible distributions are tax-free, so as the money grows, it is not subject to taxes upon withdrawals.

Insolvency: A state where an individual or organization can no longer meet financial obligations with lender(s) when their debts come due.

Interest: Interest is the amount paid on a loan or line of credit that exceeds the repayment of the principal balance.

Journal Entry (JE): Journal Entries are how updates and changes are made to a company's books. Every Journal Entry must consist of a unique identifier (to record the entry), a date, a debit/credit, an amount, and an account code (that determines which account is altered).

Liabilities (Current & Long-term): A company's debts or financial obligations incurred during business operations. Current liabilities (CL) are those debts that are payable within a year, such as a debt to suppliers. Long-term liabilities (LTL) are typically payable over a period of time greater than one year. An example of a long-term liability would be a multi-year mortgage for office space.

Limited Liability Company (LLC): An LLC is a corporate structure where members cannot be held accountable for the company's debts or liabilities. This can shield business owners from losing their entire life savings if, for example, someone were to sue the company.

Liquidity: A term referencing how quickly something can be converted into cash. For example, stocks are more liquid than a house since you can sell stocks (turning it into cash) more quickly than real estate.

Material: Material is the term that refers to whether information influences decisions. For example, if a company has revenue in the millions of dollars, an amount of $0.50 is hardly material. GAAP requires that all Material considerations must be disclosed.

Net Income (NI): Net Income is the dollar amount that is earned in profits. It is calculated by taking revenue and subtracting all of the expenses in a given period, including COGS, overhead, depreciation, and taxes.

Net Margin: Net Margin is the percent amount that illustrates the profit of a company in relation to its Revenue. It is calculated by taking net Income and dividing it by revenue for a given period.

On Credit/On Account: A purchase that happens On Credit or On Account is a purchase that will be paid at a future time, but the buyer gets to enjoy the benefit of that purchase immediately. “Bartender, put it on my tab…”.

Overhead: Overhead are those Expenses that relate to running the business. They do not include Expenses that make the product or deliver the service. For example, Overhead often includes Rent, and Executive Salaries.

Payroll: Payroll is the account that shows payments to employee salaries, wages, bonuses, and deductions. Often this will appear on the Balance Sheet as a Liability that the company owes if there is accrued vacation pay or any unpaid wages.

Present Value (PV): The current value of a future sum of money based on a specific rate of return. Present value helps us understand how receiving $100 now is worth more than receiving $100 a year from now, as money in hand now has the ability to be invested at a higher rate of return. It refers to the value of an asset today, as opposed to a different point in time. It is based on the theory that cash today is more valuable than cash tomorrow, due to the concept of inflation.

Receipts: A receipt is a document that proves payment was made. A business produces receipts when it provides its product or service and it receives receipts when it pays for goods and services from other businesses. Received receipts should be saved and catalogued so that a company can prove that its incurred expenses are accurate.

Return On Investment (ROI): A measure used to evaluate the financial performance relative to the amount of money that was invested. The ROI is calculated by dividing the net profit by the cost of the investment. The result is often expressed as a percentage.

Revenue (Sales) (Rev): Revenue is any money earned by the business.

Subchapter S Corporation (S-CORP): (USA) A form of corporation (that meets specific IRS requirements) and has the benefit of being taxed as a partnership versus being subject to the “double taxation” of dividends with public companies.

Trial Balance (TB): Trial Balance is a listing of all accounts in the General Ledger with their balance amount (either debit or credit). Mathematically the total debits must equal the total credits, hence the balance.

Variable Cost (VC): These are costs that change with the volume of sales and are the opposite of fixed costs. Variable costs increase with more sales because they are an expense that is incurred in order to deliver the sale. For example, if a company produces a product and sells more of that product, they will require more raw materials in order to meet the increase in demand.

In the years ahead these terms will most likely become second nature and part of your vocabulary. There are plenty more terms that will also be learned, but this foundation of terms will help you jump into the conversation and understand your finances.

Knowing your finances is important to know where your business is headed. You won’t know why your company isn’t profitable if you don’t know if you are profitable.