

# Glossary

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**accounting change:** Any variation in the way that accounts are prepared. Various events could account for the change, such as new Internal Revenue Service regulations or the adoption of new methods in allowing for doubtful (probably noncollectible) accounts receivable. Whenever such a change occurs, accountants are expected to footnote any financial statement, offering a full explanation of the reason for the change.

**accounts payable:** What a company owes to outside suppliers/vendors. Accounts payable are considered to be part of a company's short-term debt and are recorded as a liability on the balance sheet.

**accounts receivable:** What a company is owed from customers who have purchased its goods or services. Accounts receivable are considered to be an asset on the company's balance sheet.

**accretion:** Growth in the value of assets.

**acid-test ratio:** See *quick ratio*.

**addbacks:** Discretionary (nonessential to operations) items in the profit-and-loss statement. These items are added back to net pretax operating profit to estimate a company's economic cash flow versus cash flow produced for tax purposes.

**adjusted book value:** The book value that results after asset or liability amounts are added, deleted, or changed from their respective book amounts to their fair market value.

**adjusted book value method:** A valuation method based mainly on the balance sheet of a business in which owners' equity — total assets minus total liabilities — sets the price. In essence, the entire balance sheet is restated to current fair market value. The resulting equity is the adjusted book value.

**AICPA:** American Institute of Certified Public Accountants, the leading organization of CPAs, many of whom are trained to do business valuations.

**amortization:** The gradual, periodic reduction of any amount, such as an intangible asset, a bond premium, or the payment of a mortgage or business loan.

**angel investor:** A person who provides capital to one or more startup or early-stage companies, usually someone who is affluent or has a personal stake in the success of the venture. Valuation professionals may be brought in to put a dollar value on the potential business or idea.

**appraisal:** A professional written opinion of the value of an asset. An appraisal usually is required when a property is bought, sold, taxed, insured, or financed.

**appraisal date:** Same as the valuation date.

**appraiser:** A trained professional who has the knowledge and expertise necessary to estimate the value of an asset. An appraiser acts independently of the buying and selling parties in a transaction to arrive at the fair market value of an asset without allegiance to either party.

**appreciation:** An increase in the value of an asset.

**asset:** An item with an economic value that can be measured. Example assets include office equipment, accounts receivable, securities, real estate, and vehicles.

**asset approach:** A set of business valuation methods that determines a company's value based on the value of its assets. The valuation methods commonly used in this approach are book value; adjusted book value; liquidation value; and sometimes the capitalized excess earnings method, which is a hybrid of the asset and income approaches. See also *income approach*.

**audit:** A review of a company's finances or procedures. The four basic kinds of company audits are

- ✓ **Financial:** A formal review of a company's financial records by a licensed certified public accountant to make sure that they conform to generally accepted auditing procedures, leading to an audit opinion
- ✓ **Compliance:** An audit that determines whether a company is operating according to national rules and regulations, as well as the regulations of the jurisdiction in which it operates
- ✓ **Management:** An audit that evaluates how well a company's executives are doing their jobs
- ✓ **Internal:** An audit that represents an investigation by the company of its own procedures.

**audit documentation:** The written record of the basis for an auditor's findings. This record may also be referred to as *work papers or working papers*.

**auditor:** A person who tests the accuracy of financial accounts and records kept by others. Auditors typically are employed by public accounting firms.

**bad debt:** All or a portion of an account, loan, or other form of receivable that's considered to be uncollectible.

**balance sheet:** The assets, liabilities, and equity of a public or private corporation at a specific point in time. This document is where you go to determine what the company is actually worth on a book-value basis. See also *book value*.

**bankruptcy:** A federal court proceeding in which the assets of an insolvent debtor or company are liquidated and the debtor or company is relieved of further liability.

**bonds:** An interest-bearing certificate, usually issued by corporations and government agencies, that promises to pay interest and principal at specified times. Typically, investors try to diversify their investment portfolios with both stocks and bonds, because the value of bonds typically moves inversely to the value of stocks.

**book value:** The net value (original cost less depreciation) shown for an asset on a company's balance sheet; also called *net asset value*. Book value is considered to be one of the most controversial measurements in value investing; some people maintain that book values can be outdated and therefore are not good current measurements of a company's liquidating value.

**business broker:** A professional who assists in the buying and selling of businesses.

**business plan:** A written document created by a potential business owner that lists the objectives of the business and the steps and financing necessary to achieve those objectives.

**buy/sell agreement:** A provision of a franchise agreement that states specifically when and how an existing franchise can be bought or sold.

**capital:** Cash or goods used to generate income either by investing in a business or a different income property.

**capital gains:** The monetary gains on an investment when an investor sells and the principal has increased in value.

**capitalization:** The total market value of a stock, determined by multiplying the number of shares by the market price.

**capitalization of earnings method:** A method that sets a company's value by dividing the expected economic benefit to the business (such as the seller's discretionary cash flow) by its capitalization rate.

**capitalization of excess earnings method:** A hybrid of the asset and income approaches that calculates a company's value as the total of its net tangible assets and its goodwill. See also *asset approach* and *income approach*.

**capitalization rate:** A calculation that converts a single year's income expectancy to an indication of value by dividing the income estimate by an appropriate rate.

**cash flow:** Cash receipts less cash disbursements for a particular period. If, in a given month, a company pays out \$30,000 and collects \$40,000, its cash flow for the month is \$10,000. *Free cash flow* is the amount left after all normal capital spending, debt service, and tax payments have occurred.

**certified public accountant (CPA):** An accountant who has passed the Uniform CPA Examination administered by AICPA and is licensed by the state in which he or she practices to use that title. A CPA is authorized to write an audit opinion or audit report on a company's financial statements and can act as a final auditing authority. See also *AICPA*.

**closely held corporation:** A company that has only a few shareholders. It differs from a privately held corporation in that it trades shares (but very few shares are actually traded).

**combined financial statement:** A financial statement in which the income statements and balance sheets of related business entities (such as subsidiaries of the same holding company) are combined so that they may be considered to be one reporting entity.

**company:** A formal business enterprise set up to make a profit. Companies include corporations, partnerships, and sole proprietorships.

**consolidated statement:** A report issued by a holding company that consolidates all of its subsidiaries' earnings, assets, and liabilities. Sometimes, a consolidated statement makes it tough to look at the results of individual operations.

**corporation:** A business entity with legal status in which ownership is vested in those who purchase its stock and in so doing contribute capital to fund the business. For purposes of taxation or responsibility for liabilities, however, a corporation is regarded as being a legal entity separate from its shareholder-owners. A corporation is formed when its founders file articles of incorporation with the relevant state authority — usually, the secretary of state.

**current assets:** All assets that are convertible to cash within one year.

**debt restructuring:** A change in a company's debt structure reflecting concessions granted by its creditors. Debt restructuring usually is an indication that a company is in financial difficulties.

**debt-to-equity ratio:** A way to figure out which group provides most of the firm's capital: owners or lenders. This ratio also indicates whether a company can repay its obligations. If the ratio climbs, the company may be taking on too much debt.

**discounted cash flow method:** A valuation method that measures the value of the expected economic benefits stream in present-day dollars, given the risks associated with owning and operating a small business.

**earnings:** The amount of money that a company has left over after paying all its bills and other obligations. The company may distribute a portion or all of its earnings to investors in the form of stock or cash dividends, or it may reinvest those earnings in the business to help it grow.

**employee stock ownership plan:** A trust set up by a company to give its stock to employees over time as a tax- and estate-planning vehicle.

**equity:** Also called *net worth*. In accounting, equity is assets minus liabilities. In a sole proprietorship, equity belongs to the owner; in a corporation, it belongs to the stockholders.

**equity financing:** A way to finance a company by issuing stock to investors who give money in exchange to build the business.

**extraordinary item:** A one-time event that affects the company's earnings for one quarter or year. From a valuation standpoint, extraordinary items are important signals that a company is in for long-term problems that may depress or raise its value.

**fair market value:** The monetary amount that a buyer may reasonably offer and a seller may accept in exchange for the asset.

**fairness/solvency opinion:** Independent, objective analysis of a proposed deal's financial aspects from the point of view of one or more of the parties in the transaction.

**franchise:** A license that awards rights from a franchisor to a franchisee to use specific trademarks, business systems, and a business concept.

**franchise agreement:** The legal document that governs the franchisor–franchisee relationship and specifies the terms of the franchise purchase. A typical franchise agreement may include specific details on the following:

- ✓ The franchise system, such as use of trademarks and products
- ✓ Territory
- ✓ Rights and obligations of the parties: standards, procedures, training, assistance, advertising, and so on
- ✓ Term (duration) of the franchise agreement
- ✓ Payments made by the franchisee to the franchisor
- ✓ Termination and/or right to transfer the franchise

**fundamental analysis:** A method of stock analysis that relies on the reported numbers of a company for investment decisions, as opposed to technical analysis, which looks at the price and volume history of a stock. Fundamental analysis is an important factor in value investing.

**generally accepted accounting principles (GAAP):** The financial reporting standards with which all public companies must comply so that each annual or quarterly report is uniform. Whenever a company’s results fail to meet these principles, this failure indicates problems or changes in the company’s financial fortunes.

**generally accepted auditing standards (GAAS):** Guidelines that auditors follow in preparing (and certifying) financial statements for clients. Any certified public accountant who doesn’t follow these guidelines is in violation of AICPA rules and can be held legally liable by clients. See also *AICPA*.

**goodwill:** An intangible asset of a company, usually quantified when a company is purchased, the amount being the excess over book value.

**income approach:** A family of valuation methods that determines the value of a business based on its ability to generate desired economic benefit for the owners.

**income statement:** Also called the *profit-and-loss statement* or *P&L*. This document is used in combination with the company’s balance sheet to provide an overall look at the company’s finances.

**incorporation:** It is the process of turning a business into one that is separate from its owners. A corporation accomplishes several goals. It protects the owner’s assets against the company’s liabilities, can achieve a lower tax rate than on an owner’s personal income and allows owners to raise capital through the sale of stock.

**intangible assets:** Assets without a strict dollar value in the form of goodwill, patents, trademarks, copyrights, and trade names.

**inventory:** Goods made and held by a company for sale. Inventory is important as long as a company keeps up with demand, but if demand falls, inventory is a burden.

**liabilities:** What a company owes in the form of accounts payable, bank borrowings, or bond indebtedness.

**liquid asset:** An asset that can be converted to cash within 30 days.

**liquidation value:** The value of a company based on a plan to close it as a going concern and simply sell off the assets.

**liquidity:** The degree of ease and certainty of value with which a security can be converted to cash.

**market-based business valuation:** A general way of setting value by comparing the business with similar businesses.

**multiple of discretionary earnings business valuation method:** A method that establishes value by multiplying the seller's discretionary cash flow by a factor derived from the business, industry, and market, as well as owner preferences.

**net income:** The amount of income, or profit, after all the bills and obligations have been paid at a company.

**partnership:** A kind of business organization in which two or more people contribute capital and their services to the organization.

**portfolio:** A group of investments.

**preferred stock:** A security representing prior claim to common stock on the firm's earnings and assets. Preferred stockholders normally forgo voting rights and receive a fixed dividend that takes precedence over payment of dividends to common stockholders.

**price-to-book ratio:** Market price per share divided by book value (tangible assets less all liabilities) per share; a measure of stock valuation relative to net assets.

**pro forma statement:** A calculated guess about the future earnings or balance sheet of a company, usually part of initial public offering documents or merger and acquisition proposals.

**quick ratio:** A method of analyzing a balance sheet, in which inventory is subtracted from current assets and the result is divided by current liabilities. The quick ratio is also known as the *acid-test ratio* because it indicates how much money is truly available for current needs.

**receivables:** Money owed to a company that is payable within a specified period.

**retained earnings:** The earnings that a company keeps after paying interest, dividends, salaries, and all bills.

**return on assets (ROA):** A way to assess how much a company earns on each dollar of assets.

**return on investment (ROI):** The most common profitability ratio, reached by dividing net profit by net worth.

**revenue:** Total sales of a company.

**S corporation:** A profitmaking corporation whose shareholders have received subchapter S corporation status from the Internal Revenue Service.

**seller's discretionary cash flow:** The pretax earnings of a business before noncash expenses, a single owner's compensation, interest expense, or income, as well as one-time and nonbusiness-related income and expense items.

**Small Business Administration:** A federal agency that helps small business with operational, financial, and regulatory issues: [www.sba.gov](http://www.sba.gov).

**sole proprietorship:** An unincorporated business (usually, a small business) with just one owner. The disadvantage of such a business entity is that the sole proprietor is directly responsible for all the debts of the business.

**undercapitalization:** A company's lack of enough cash on hand to continue business operations or pay its creditors.

**value:** A quality, feature, or function of a business that makes customers and investors want to put money into it.

**valuation date:** The official date of a company's valuation – a frozen point in time where all parties can look at it's valuation as a means of making a business decision.

**venture capital:** A fund-raising technique for companies that are willing to exchange equity for money to grow or expand the business. See also *angel investor*.

**working capital:** The excess of a company's current assets over its current liabilities — that is, cash plus accounts receivable plus inventory minus the sum of accounts payable plus accrued liabilities and short-term loans.