

Common Financial Terms and What They Really Mean

Sherrri S. Holder, CPA/ABV/CFF, CVA



Thurman Holder Gibbon, LLC

770.579.3860

sherri.holder@thgcpa.net

Topics we will cover

1. Income v. Distributions
2. Retained Earnings
3. Book Value
4. Capital Account
5. Equity
6. Goodwill
7. Accrual Accounting
8. Capitalization Rate
9. Pro Forma Financial Statements
10. Alimony
11. Head of Household
12. Non-Qualified Retirement Plans

Income

Definition

Inflow of revenue during a period of time.

Income

What it Really Means

The gross sales or revenue of a business. What the company receives for providing services or selling goods. For most service businesses it is the gross collections.

Net Income

Definition

Excess or deficit of total revenues and gains compared with total expenses and losses for an accounting period.

Net Income

What it Really Means

This is the amount earned by the company less the costs of the business for the year. This is the “bottom line” for the company. It is the amount that the entity is taxed on. If the entity is an S Corp, partnership, or LLC it is the amount that the owners are taxed on.

STATEMENT OF INCOME AND RETAINED EARNINGS

	2009	2008	2007
INCOME			
Revenues	1,000,000	800,000	500,000
Cost of Revenues	500,000	400,000	250,000
Gross Profit	<u>500,000</u>	<u>400,000</u>	<u>250,000</u>
 GENERAL AND ADMINISTRATIVE EXPENSE			
Salaries	200,000	180,000	175,000
Rent	50,000	50,000	50,000
Auto	5,000	4,500	4,200
Depreciation	4,500	4,500	4,500
Utilities	10,000	9,500	9,000
Total General and Administrative Expense	<u>269,500</u>	<u>248,500</u>	<u>242,700</u>
 OPERATING INCOME	 230,500	 151,500	 7,300
 OTHER INCOME (EXPENSE)			
Interest Income	1,000	750	-
Loss on Sale of Equipment	(8,000)	-	-
 NET INCOME	 223,500	 152,250	 7,300
 Add Retained Earnings, beginning of year	 69,550	 7,300	 -
Less distributions paid	(125,000)	(90,000)	-
Retained Earnings, end of year	<u>168,050</u>	<u>69,550</u>	<u>7,300</u>

Distributions

Definition

Payment by a business entity to its owners of items such as cash assets, stocks, or earnings.

Distributions

What it Really Means

For a flow through entity such as an S Corp, Partnership or Limited Liability Company (LLC) distributions are the amounts the company gives to the owners, not including salary. This includes amounts used to pay taxes on the income plus any other amounts paid from its profits. Many S Corps and partnerships that have bank loans are restricted by the lender and permitted to only make distributions sufficient to pay the taxes resulting from the income of the entity. Distributions are not additional income from the entity. They are only a payout of the income. As such, the owner is not taxed on the amount of the distribution. They are taxed on the amount of taxable income. Distributions can be more or less than the actual income of the company.

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Retained Earnings

Definition

Accumulated undistributed earnings of a company retained for future needs or for future distribution to its owners. It is the accumulated earnings (or losses) during the life of the company that has not been paid out as dividends or distributions. The amount of the accumulated earnings is reduced by distributions to shareholders and transfers to additional paid in capital for stock dividends. Retained earnings do not include treasury stock.

Retained Earnings

What it Really Means

The cumulative profit of a company that has not been paid out to its owners. It is not cash sitting in a bank account somewhere. The value may be held in cash, accounts receivable, inventory, fixed assets, or other assets of the company. It is the profits of the business that have been reinvested in the business.

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BALANCE SHEET

ASSETS

	2009	2008	2007
CURRENT ASSETS			
Cash and Equivalents	126,550	50,000	2,000
Accounts Receivable	150,000	80,000	50,000
Prepaid Expenses	12,000	10,000	15,000
Total Current Assets	288,550	140,000	67,000
PROPERTY & EQUIPMENT			
Vehicles	50,000	50,000	50,000
Furniture & Equipment	10,000	10,000	10,000
Leasehold Improvements	65,000	65,000	65,000
Accumulated Depreciation	(13,500)	(9,000)	(4,500)
Net Property & Equipment	111,500	116,000	120,500
Goodwill	47,800	47,800	47,800
TOTAL ASSETS	447,850	303,800	235,300

LIABILITIES

CURRENT LIABILITIES			
Accounts Payable	85,000	31,250	18,000
Accrued Expenses	16,800	12,000	5,000
Total Current Liabilities	101,800	43,250	23,000
LONG TERM DEBT			
Notes Payable	148,000	161,000	175,000
TOTAL LIABILITIES	249,800	204,250	198,000

SHAREHOLDER'S EQUITY

Common Stock	5,000	5,000	5,000
Additional Paid in Capital	25,000	25,000	25,000
Retained Earnings	168,050	69,550	7,300
TOTAL SHAREHOLDER'S EQUITY	198,050	99,550	37,300
TOTAL LIABILITIES AND SHAREHOLDER'S EQUITY	447,850	303,800	235,300

Capital Account

Definition

An account stating the amount of funds and assets invested in a business by the owners or stockholders, including retained earnings.

Capital Account

What it Really Means

It is the total amount that has been invested in the company, either through actual cash investments or retained earnings that have not been distributed back out.

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Equity

Definition

Residual interest in the assets of an entity that remains after deducting its liabilities. Also, the amount of a business' total assets less total liabilities. It is reported in the third section of a balance sheet, the other two being assets and liabilities. It is referred to as owner's equity in a sole proprietorship or partnership and stockholder's equity or shareholder's equity in a corporation.

Equity

What it Really Means

It is the difference between the assets and liabilities reported on the balance sheet of the company. It is the cumulative amount of the funds invested in the business adjusted for the net income of the business and reduced for any amounts withdrawn from the business. For an asset such as a house it is the value of the asset less any debt secured by the asset.

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Book Value

Accounting Definition

Amount, net of contra account balances that an asset or liability shows on the balance sheet of a company. Also known as carrying value.

Valuation Definition – Net Book Value

With respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion, and amortization) and total liabilities as they appear on the balance sheet (synonymous with Shareholder's Equity.) With respect to a specific asset, the capitalized cost less accumulated amortization or depreciation as it appears on the books of account of the business enterprise.

Book Value

What it Really Means

With respect to an asset, the actual amounts paid for an asset adjusted for depreciation amortization, but NOT adjusted to reflect the actual market value.

With respect to an entity, the investment in the entity, adjusted for net income, but not adjusted to reflect the change in market values of the underlying assets or the goodwill of the entity.

Basically, it is what the owners have “in it.”

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Goodwill

Accounting Definition

Premium paid in the acquisition of an entity over the fair value of its identifiable tangible and intangible assets less liabilities assumed.

Valuation Definition

That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.

Goodwill

What it Really Means - Accounting

It is the leftover numbers. When a business buys another business it must assign the purchase price to the assets of the business based on the value of the assets such as the cash, accounts receivable, inventory, equipment, etc. If the purchase price is more than the value of the assets, the excess is assigned to goodwill. In other words, the “leftover numbers.”

What it Really Means – Valuation

The value of a business in excess of the hard assets of the company. It is not a tangible asset, but it is saleable.

Accrual Accounting

Definition

The attempt to record the financial effects of transactions and other events in the periods in which those transactions or events occur rather than only in the periods in which cash is received or paid by the business, using all the techniques developed by accountants to apply the matching principle.

Accrual Accounting

What it Really Means

Recognizing income when it is earned rather than when it is received and recognizing expenses when they are owed rather than when they are paid. For most businesses it means that the income includes gross billings, not just gross collections, and the expenses include amounts that are payable or otherwise incurred in addition to the expenses actually paid.

Pro Forma

Definition

Presentation of financial information, excluding unusual and non-recurring items, that gives effect to an assumed event (e.g., Merger).

Pro Forma

What it Really Means

The numbers that pro forma reports are not actual. The numbers are made up with most of the bad stuff being left out.

Capitalization Rate

Definition

Any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value.

Capitalization Rate

What it Really Means

The rate of return adjusted for anticipated growth expected of an investment. It is divided into the expected ongoing net cash flow of a business to determine an indication of value. It is the reciprocal of an earnings multiple. In other words, a 5x earnings multiple in a business valuation is a capitalization of $1/5$ or 20%.

Alimony

Definition

Payments made under a divorce or separation instrument are includable in the gross income of the recipient and deductible by the payor if the following requirements are met: (1) the payment is in cash or its equivalent, (2) the payment is received by or on behalf of a spouse under a divorce or separation instrument, (3) the instrument does not designate the payment as not includable in gross income and not allowable as a deduction under Code Sec. 215, (4) spouses who are legally separated under a decree of divorce or separate maintenance cannot be members of the same household at the time the payment is made, (5) there is no liability to make any payment for any period after the death of the payee spouse or to make any payment (either in cash or property) as a substitute for such payments after the death of the payee spouse, and (6) the spouses must not file joint returns with each other (Code Sec. 71 (a), (b) and (e)).

Alimony

What it Really Means

Payments to a former spouse in cash that are contingent in that they must end at the death of the former spouse. In such case the payments are deductible by the payee spouse and taxable to the recipient.

Alimony

Tax Tip

Watch out for tax payments that decrease during the 2nd and 3rd calendar year after the payments start. These payments can trigger alimony recapture and alter the tax effect.

Watch out for payments that end at dates related to the children.

Head of Household

Definition

A portion of the benefits that the more favorable tax rates bestow upon a married couple filing a joint return are given to an unmarried individual who qualifies as the “head of a household.” In order to qualify for head of household status, a taxpayer must not be married or a surviving spouse at the close of the tax year. In addition the taxpayer must maintain as his home a household which, for more than one –half of the tax year, is the principal place of abode of one of the following who is a member of such household: (see handout for full definition)

Head of Household

Divorce Tip

Both spouses can qualify as head of household which means they can use lower tax rates than a single filer. In order to qualify the parties would need to have joint physical custody and at least two children. Each party would need to have a child live with them more than 50% percent of the time.

Non-Qualified Retirement Plans

Definition

Any type of tax deferred, employer sponsored retirement plan that does not meet the IRS or ERISA requirements for favorable tax treatment. Non-qualified retirement plans are funded by employers and are more flexible, but do not have the tax benefits of qualified retirement plans. They are designed to meet the retirement needs for key executives. They are exempt from the discriminatory and top heavy testing that qualified plans are subject to. Benefits are paid at the retirement age and are taxed as ordinary income.

Non-Qualified Retirement Plans

Tax Tip

These plans are not divisible via Qualified Domestic Relations Order. You will need to review the plan documents to see if the plan is divisible. If not, the value needs to be offset with other assets or can be paid out as alimony when the recipient begins receiving benefits.