

**Revenues-** The amount of money that a company actually receives during a specific period, including discounts and deductions for returned merchandise. It is the "top line" or "gross income" figure from which costs are subtracted to determine net income. Revenue is calculated by multiplying the price at which goods or services are sold by the number of units or amount sold. Revenue is also known as "REVs." Revenue is the amount of money that is brought into a company by its business activities. In the case of government, revenue is the money received from taxation, fees, fines, inter-governmental grants or transfers, securities sales, mineral rights and resource rights, as well as any sales that are made.

**Cost of Goods Sold-** The direct costs attributable to the production of the goods sold by a company. This amount includes the cost of the materials used in creating the good along with the direct labor costs used to produce the good. It excludes indirect expenses such as distribution costs and sales force costs. COGS appears on the **income statement** and can be deducted from **revenue** to calculate a company's **gross margin**. Also referred to as "cost of sales." COGS is the cost of creating the products that a company sells; therefore, the only costs included in the measure are those that are directly tied to the production of the products.

For example, the COGS for an automaker would include the material costs for the parts that go into making the car along with the labor costs used to put the car together. The cost of sending the cars to dealerships and the cost of the labor used to sell the car would be excluded.

The exact costs included in the COGS calculation will differ from one type of business to another. The cost of goods attributed to a company's products are expensed as the company sells these goods. There are several ways to calculate COGS but one of the more basic ways is to start with the beginning **inventory** for the period and add the total amount of purchases made during the period, and then deducting the ending inventory. This calculation gives the total amount of inventory or, more specifically, the cost of this inventory, sold by the company during the period. Therefore, if a company starts with \$10 million in inventory, makes \$2 million in purchases and ends the period with \$9 million in inventory, the company's cost of goods for the period would be \$3 million (\$10 million + \$2 million - \$9 million).

**gross margin-** A company's total sales revenue minus its cost of goods sold, divided by the total sales revenue, expressed as a percentage. The gross margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company. The higher the percentage, the more the company retains on each dollar of sales to service its other costs and obligations.

$$\text{Gross Margin (\%)} = \frac{\text{Revenue} - \text{Cost of Goods Sold}}{\text{Revenue}}$$

This number represents the proportion of each dollar of revenue that the company retains as gross profit. For example, if a company's gross margin for the most recent quarter was 35%, it would retain \$0.35 from each dollar of revenue generated, to be

put towards paying off selling, general and administrative expenses, interest expenses and distributions to shareholders. The **levels of gross margin can vary drastically from one industry to another** depending on the business. For example, software companies will generally have a much higher gross margin than a manufacturing firm.

**SG&A/ SELLING, GENERAL & ADMINISTRATIVE EXPENSE-** Reported on the income statement, it is the sum of all direct and indirect selling expenses and all general and administrative expenses of a company.

Direct selling expenses are expenses that can be directly linked to the sale of a specific unit such as credit, warranty and advertising expenses. Indirect selling expenses are expenses which cannot be directly linked to the sale of a specific unit, but which are proportionally allocated to all units sold during a certain period, such as telephone, interest and postal charges. General and administrative expenses include salaries of non-sales personnel, rent, heat and lights. High SG&A expenses can be a serious problem for almost any business. Examining this figure as a percentage of sales or net income compared to other companies in the same industry can give some idea of whether management is spending efficiently or wasting valuable cash flow. For example, in the television industry businesses that depend on a great deal of advertising must carefully monitor their marketing expenses. A good management team will often attempt to keep SG&A expenses under tight control and limited to a certain percentage of revenue by reducing corporate overhead (i.e. cost-cutting, employee lay-offs).

**operating margin-** A ratio used to measure a company's pricing strategy and operating efficiency.

$$\text{Operating Margin} = \frac{\text{Operating Income}}{\text{Net Sales}}$$

Calculated as:

Operating margin is a measurement of what proportion of a company's revenue is left over after paying for variable costs of production such as wages, raw materials, etc. A healthy operating margin is required for a company to be able to pay for its fixed costs, such as interest on debt.

Also known as "operating profit margin" or "net profit margin". Operating margin gives analysts an idea of how much a company makes (before interest and taxes) on each dollar of sales. When looking at operating margin to determine the quality of a company, it is best to look at the change in operating margin over time and to compare the company's yearly or quarterly figures to those of its competitors. If a company's margin is increasing, it is earning more per dollar of sales. The higher the margin, the better.

For example, if a company has an operating margin of 12%, this means that it makes \$0.12 (before interest and taxes) for every dollar of sales. Often, nonrecurring cash flows, such as cash paid out in a lawsuit settlement, are excluded from the operating

margin calculation because they don't represent a company's true operating performance.

**net (profit) margin-** The ratio of net profits to revenues for a company or business segment - typically expressed as a percentage – that shows how much of each dollar earned by the company is translated into profits. Net margins can generally be calculated as:

$$\text{Net Margins} = \frac{\text{Net Profit}}{\text{Revenue}}$$

, where **Net Profit = Revenue - COGS - Operating Expenses - Interest and Taxes**

Net margins will vary from company to company, and certain ranges can be expected from industry to industry, as similar business constraints exist in each distinct industry. A company like Wal-Mart has made fortunes for its shareholders while operating on net margins less than 5% annually, while at the other end of the spectrum some technology companies can run on net margins of 15-20% or greater. Most publicly traded companies will report their net margins both quarterly (during earnings releases) and in their annual reports. Companies that are able to expand their net margins over time will generally be rewarded with share price growth, as it leads directly to higher levels of profitability.

**earnings per share(EPS)-** Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio. For example, assume that a company has a net income of \$25 million. If the company pays out \$1 million in preferred dividends and has 10 million shares for half of the year and 15 million shares for the other half, the EPS would be \$1.92 (24/12.5). First, the \$1 million is deducted from the net income to get \$24 million, then a weighted average is taken to find the number of shares outstanding (0.5 x 10M+ 0.5 x 15M = 12.5M).

An important aspect of EPS that's often ignored is the capital that is required to generate the earnings (net income) in the calculation. Two companies could generate the same EPS number, but one could do so with less equity (investment) - that company would be more efficient at using its capital to generate income and, all other things being equal, would be a "better" company. Investors also need to be aware of earnings manipulation that will affect the quality of the earnings number. It is important not to rely on any one financial measure, but to use it in conjunction with statement analysis and other measures.

**pro forma earnings-** Projected earnings based on a set of assumptions and often used to present a business plan (in Latin pro forma means "for the sake of form"). It also refers to earnings which exclude non-recurring items. Pro-forma earnings are not derived by standard GAAP methods. Items sometimes excluded in

pro-forma earnings figures include write-downs, goodwill amortization, depreciation, restructuring and merger costs, interest, taxes, stock based employee pay and other expenses. The company excludes these items with the intent to present its figures more clearly to investors. However, whether or not this is accomplished is debatable. This has spawned such nicknames for pro-forma earnings as EEBS (earnings excluding bad stuff).

Investors should exercise caution when using pro-forma earnings figures in their fundamental analysis. Unlike GAAP earnings, pro-forma earnings do not comply with any standardized rules or regulations. As a result, positive pro-forma earnings can become negative once GAAP requirements are applied and certain items are included in the calculations!

**option expense-** is a method of accounting for the value of share options, distributed as incentives to employees, within the profit and loss reporting of a listed business. On the income statement, balance sheet, and cash flow statement say that the loss from the exercise is accounted for by noting the difference between the market price (if one exists) of the shares and the cash received, the exercise price, for issuing those shares through the option.

Opponents of considering options an expense say that the real loss- due to the difference between the exercise price and the market price of the shares- is already stated on the cash flow statement. They would also point out that a separate loss in earnings per share (due to the existence of more shares outstanding) is also recorded on the balance sheet by noting the dilution of shares outstanding. Simply, accounting for this on the income statement is believed to be redundant to them.

Note: Currently, the future appreciation of all shares issued are not accounted for on the income statement but can be noted upon examination of the balance sheet and cash flow statement.

**Dilution-** A reduction in the ownership percentage of a share of stock caused by the issuance of new stock. Dilution can also occur when holders of stock options (such as company employees) or holders of other optionable securities exercise their options. When the number of shares outstanding increases, each existing stockholder will own a smaller, or diluted, percentage of the company, making each share less valuable. Dilution also reduces the value of existing shares by reducing the stock's earnings per share. Suppose a company has issued 100 shares to 100 unique shareholders. Each shareholder owns 1% of the company. If the company then has a secondary offering and issues 100 new shares to 100 more unique shareholders, each shareholder will only own 0.5% of the company. The smaller ownership percentage also diminishes each investor's voting power. Share dilution may be imminent any time a company needs additional capital. The potential upside of share dilution is that the additional capital the company receives

from issuing additional shares can improve the company's profitability and the value of its stock.

**share repurchase-** A program by which a company buys back its own shares from the marketplace, reducing the number of outstanding shares. Share repurchase is usually an indication that the company's management thinks the shares are undervalued. The company can buy shares directly from the market or offer its shareholder the option to tender their shares directly to the company at a fixed price. Because a share repurchase reduces the number of shares outstanding (i.e. supply), it increases earnings per share and tends to elevate the market value of the remaining shares. When a company does repurchase shares, it will usually say something along the lines of, "We find no better investment than our own company."

**IPO-** The first sale of stock by a private company to the public. IPOs are often issued by smaller, younger companies seeking the capital to expand, but can also be done by large privately owned companies looking to become publicly traded. In an IPO, the issuer obtains the assistance of an underwriting firm, which helps it determine what type of security to issue (common or preferred), the best offering price and the time to bring it to market. Also referred to as a "public offering." IPOs can be a risky investment. For the individual investor, it is tough to predict what the stock will do on its initial day of trading and in the near future because there is often little historical data with which to analyze the company. Also, most IPOs are of companies going through a transitory growth period, which are subject to additional uncertainty regarding their future values.

**secondary offering-** 1. The issuance of new stock for public sale from a company that has already made its initial public offering (IPO). Usually, these kinds of public offerings are made by companies wishing to refinance, or raise capital for growth. Money raised from these kinds of secondary offerings goes to the company, through the investment bank that underwrites the offering. Investment banks are issued an allotment, and possibly an over-allotment which they may choose to exercise if there is a strong possibility of making money on the spread between the allotment price and the selling price of the securities. 2. A sale of securities in which one or more major stockholders in a company sell all or a large portion of their holdings. The proceeds of this sale are paid to the stockholders that sell their shares. Often, the company that issued the shares holds a large percentage of the stocks it issues.

**free cash flow-** Some believe that Wall Street focuses myopically on earnings while ignoring the "real" cash that a firm generates. Earnings can often be clouded by accounting gimmicks, but it's tougher to fake cash flow. For this reason, some investors believe that FCF gives a much clearer view of the ability to generate cash (and thus profits). It is important to note that negative free cash flow is not bad in itself. If free cash flow is negative, it could be a sign that a company is making large

investments. If these investments earn a high return, the strategy has the potential to pay off in the long run. FCF is a better indicator than the P/E Ratio.

**price-to-earnings book and sales ratios-** In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E. However, the P/E ratio doesn't tell us the whole story by itself. It's usually more useful to compare the P/E ratios of one company to other companies in the same industry, to the market in general or against the company's own historical P/E. It would not be useful for investors using the P/E ratio as a basis for their investment to compare the P/E of a technology company (high P/E) to a utility company (low P/E) as each industry has much different growth prospects. The P/E is sometimes referred to as the "multiple", because it shows how much investors are willing to pay per dollar of earnings. If a company were currently trading at a multiple (P/E) of 20, the interpretation is that an investor is willing to pay \$20 for \$1 of current earnings.

It is important that investors note an important problem that arises with the P/E measure, and to avoid basing a decision on this measure alone. The denominator (earnings) is based on an accounting measure of earnings that is susceptible to forms of manipulation, making the quality of the P/E only as good as the quality of the underlying earnings number.

Things to Remember

Generally a high P/E ratio means that investors are anticipating higher growth in the future.

The average market P/E ratio is 20-25 times earnings.

The P/E ratio can use estimated earnings to get the forward looking P/E ratio.

Companies that are losing money do not have a P/E ratio.

**Depreciation-** 1. A method of allocating the cost of a tangible asset over its useful life. Businesses depreciate long-term assets for both tax and accounting purposes.  
2. A decrease in an asset's value caused by unfavorable market conditions.

Amortization- 1. The paying off of debt with a **fixed repayment schedule** in regular installments over a period of time. Consumers are most likely to encounter amortization with a mortgage or car loan.

2. The spreading out of **capital expenses** for intangible assets over a specific period of time (usually over the asset's useful life) for accounting and tax purposes.

Amortization is similar to depreciation, which is used for **tangible assets**, and to depletion, which is used with natural resources. Amortization roughly matches an asset's expense with the revenue it generates.

**Capital Expenditure – CAPEX-** Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations. These expenditures can include everything from repairing a roof to

building a brand new factory. The amount of capital expenditures a company is likely to have depends on the industry it occupies. Some of the most capital intensive industries include oil, telecom and utilities.

In terms of accounting, an expense is considered to be a capital expenditure when the asset is a newly purchased capital asset or an investment that improves the useful life of an existing capital asset. If an expense is a capital expenditure, it needs to be capitalized; this requires the company to spread the cost of the expenditure over the useful life of the asset. If, however, the expense is one that maintains the asset at its current condition, the cost is deducted fully in the year of the expense.

**Equity-** The term's meaning depends very much on the context. In finance, in general, you can think of equity as ownership in any asset after all debts associated with that asset are paid off. For example, a car or house with no outstanding debt is considered the owner's equity because he or she can readily sell the item for cash. Stocks are equity because they represent ownership in a company.

**Assets-** 1. A resource with economic value that an individual, corporation or country owns or controls with the expectation that it will provide future benefit.

2. A balance sheet item representing what a firm owns.

1. Assets are bought to increase the value of a firm or benefit the firm's operations.

You can think of an asset as something that can generate cash flow, regardless of whether it's a company's manufacturing equipment or an individual's rental apartment.

2. In the context of accounting, assets are either current or fixed (non-current).

Current means that the asset will be consumed within one year. Generally, this includes things like cash, accounts receivable and inventory. Fixed assets are those that are expected to keep providing benefit for more than one year, such as equipment, buildings and real estate.

**Liabilities-** A company's legal debts or obligations that arise during the course of business operations. Liabilities are settled over time through the transfer of economic benefits including money, goods or services. Recorded on the balance sheet (right side), liabilities include loans, accounts payable, mortgages, deferred revenues and accrued expenses. Liabilities are a vital aspect of a company's operations because they are used to finance operations and pay for large expansions. They can also make transactions between businesses more efficient. For example, the outstanding money that a company owes to its suppliers would be considered a liability.

Outside of accounting and finance this term simply refers to any money or service that is currently owed to another party. One form of liability, for example, would be the property taxes that a homeowner owes to the municipal government.

Current liabilities are debts payable within one year, while long-term liabilities are debts payable over a longer period.

**shareholder's equity**- A firm's total assets minus its total liabilities. Equivalently, it is share capital plus retained earnings minus treasury shares. Shareholders' equity represents the amount by which a company is financed through common and preferred shares.

**Shareholders' Equity = Total Assets - Total Liabilities**

**OR**

**Shareholders' Equity = Share Capital + Retained Earnings - Treasury Shares**

Also known as "share capital", "net worth" or "stockholders' equity". Shareholders' equity comes from two main sources. The first and original source is the money that was originally invested in the company, along with any additional investments made thereafter. The second comes from retained earnings which the company is able to accumulate over time through its operations. In most cases, the retained earnings portion is the largest component.

**Receivables**- An asset designation applicable to all debts, unsettled transactions or other monetary obligations owed to a company by its debtors or customers. Receivables are recorded by a company's accountants and reported on the balance sheet, and they include all debts owed to the company, even if the debts are not currently due. Receivables are recorded as an asset by the company because it expects to receive payment for the outstanding amounts soon. Long-term receivables, which do not come due for a significant length of time, are recorded as long-term assets on the balance sheet; most short-term receivables are considered part of a company's current assets.

**Inventories**- The raw materials, work-in-process goods and completely finished goods that are considered to be the portion of a business's assets that are ready or will be ready for sale. Inventory represents one of the most important assets that most businesses possess, because the turnover of inventory represents one of the primary sources of revenue generation and subsequent earnings for the company's shareholders/owners. Possessing a high amount of inventory for long periods of time is not usually good for a business because of inventory storage, obsolescence and spoilage costs. However, possessing too little inventory isn't good either, because the business runs the risk of losing out on potential sales and potential market share as well.

Inventory management forecasts and strategies, such as a just-in-time inventory system, can help minimize inventory costs because goods are created or received as inventory only when needed.

**Goodwill**- An intangible asset that arises as a result of the acquisition of one company by another for a premium value. The value of a company's brand name, solid customer base, good customer relations, good employee relations and any



patents or proprietary technology represent goodwill. Goodwill is considered an intangible asset because it is not a physical asset like buildings or equipment. The goodwill account can be found in the assets portion of a company's balance sheet. The value of goodwill typically arises in an acquisition when one company is purchased by another company. The amount the acquiring company pays for the target company over the target's book value usually accounts for the value of the target's goodwill. If the acquiring company pays less than the target's book value, it gains "negative goodwill," meaning that it purchased the company at a bargain in a distress sale.

Goodwill is difficult to price, but it does make a company more valuable. For example, a company like Coca-Cola (who has been around for decades, makes a wildly popular product based on a secret formula and is generally positively perceived by the public), would have a lot of goodwill. A competitor (a small, regional soda company that has only been in business for five years, has a small customer base, specializes in unusual soda flavors and recently faced a scandal over a contaminated batch of soda), would have far less goodwill, or even negative goodwill.

Because the components that make up goodwill have subjective values, there is a substantial risk that a company could overvalue goodwill in an acquisition. This overvaluation would be bad news for shareholders of the acquiring company, since they would likely see their share values drop when the company later has to write down goodwill. In fact, this happened in the AOL-Time Warner merger of 2001.

**Leverage-** 1. The use of various financial instruments or borrowed capital, such as **margin**, to increase the potential return of an investment.

2. The amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be highly leveraged.

**Leverage is most commonly used in real estate transactions** through the use of mortgages to purchase a home. 1. Leverage can be created through options, futures, margin and other financial instruments. For example, say you have \$1,000 to invest. This amount could be invested in 10 shares of Microsoft (**MSFT**) stock, but to increase leverage, you could invest the \$1,000 in five options contracts. You would then control 500 shares instead of just 10.

2. Most companies use debt to finance operations. By doing so, a company increases its leverage because it can invest in business operations without increasing its equity. For example, if a company formed with an investment of \$5 million from investors, the equity in the company is \$5 million - this is the money the company uses to operate. If the company uses debt financing by borrowing \$20 million, the company now has \$25 million to invest in business operations and more opportunity to increase value for shareholders.

**Leverage helps both the investor and the firm to invest or operate.** However, it comes with greater risk. If an investor uses leverage to make an investment and the investment moves against the investor, his or her loss is much greater than it would've been if the investment had not been leveraged - leverage magnifies both gains *and* losses. In the business world, a company can use leverage to try to

generate shareholder wealth, but if it fails to do so, the interest expense and credit risk of default destroys shareholder value.

**LEASE OBLIGATIONS-** Capital lease obligations are the amount due for long-term asset lease agreements that are nearly equivalent to asset purchases.

A company can use a capital lease to effectively finance the purchase of an asset without ever technically purchasing the asset. A capital lease gives the company control over an asset for a large portion of its useful life, with all the risks and benefits attributed to ownership. Capital leases act as a form of financing because the company does not have to purchase the asset outright, but rather, makes monthly payments for the asset. A capital lease for an asset is quite similar to a consumer's car lease.

Capital lease obligations are installment payments that constitute a payment of principal plus interest for the capital lease. Capital lease obligations are listed in the [liabilities](#) section of a [balance sheet](#) while the property or asset leased is listed in the assets section of the balance sheet. The current portion of a capital lease obligation is the portion of a long-term capital lease that is due over the next year.

Under US [Generally Accepted Accounting Principles \(GAAP\)](#), a capital lease is essentially equivalent to a purchase by the lessee if it meets the following criteria:

- Ownership of the asset is transferred to the lessee at the end of the lease term;
- The lease contains a bargain purchase option to buy the equipment at less than fair market value;
- The lease term equals or exceeds 75% of the asset's estimated useful life;

The present value of the lease payments equals or exceeds 90% of the total original cost of the equipment.

**tangible book value-** A method of valuing a company on a per-share basis by measuring its equity after removing any intangible assets.

The tangible book value per share is calculated as follows:

$$\text{Tangible Book Value Per Share} = \frac{\text{Total Tangible Assets}}{\text{Total Number of Shares Outstanding}}$$

A company's tangible book value looks at what common shareholders can expect to receive if the firm goes bankrupt and all of its assets are liquidated at their book values. Intangible assets, such as goodwill, are removed from this calculation because they cannot be sold during liquidation. Companies with high tangible book value per share provide shareholders with more insurance in case of bankruptcy.

**debt-to-equity ratio-** A measure of a company's financial leverage calculated by dividing its total liabilities by stockholders' equity. It indicates what proportion of equity and debt the company is using to finance its assets.

$$= \frac{\text{Total Liabilities}}{\text{Shareholders Equity}}$$

Note: Sometimes only interest-bearing, long-term debt is used instead of total liabilities in the calculation.

Also known as the Personal Debt/Equity Ratio, this ratio can be applied to personal financial statements as well as corporate ones.

**cash conversion cycle-** A metric that expresses the length of time, in days, that it takes for a company to convert resource inputs into cash flows. The cash conversion cycle attempts to measure the amount of time each net input dollar is tied up in the production and sales process before it is converted into cash through sales to customers. This metric looks at the amount of time needed to sell inventory, the amount of time needed to collect receivables and the length of time the company is afforded to pay its bills without incurring penalties.

Also known as "cash cycle."

Calculated as:

$$CCC = DIO + DSO - DPO$$

Where: DIO represents days inventory outstanding, DSO represents days sales outstanding, DPO represents days payable outstanding

Usually a company acquires inventory on credit, which results in accounts payable. A company can also sell products on credit, which results in accounts receivable. Cash, therefore, is not involved until the company pays the accounts payable and collects accounts receivable. So the cash conversion cycle measures the time between outlay of cash and cash recovery.

This cycle is extremely important for retailers and similar businesses. This measure illustrates how quickly a company can convert its products into cash through sales. The shorter the cycle, the less time capital is tied up in the business process, and thus the better for the company's bottom line.

**return on equity-** The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

ROE is expressed as a percentage and calculated as:

$$\text{Return on Equity} = \text{Net Income} / \text{Shareholder's Equity}$$

Net income is for the full fiscal year (before dividends paid to common stock holders but after dividends to preferred stock.) Shareholder's equity does not include preferred shares.

Also known as "return on net worth" (RONW).

**assets and invested capital-** A type of asset that is not easily sold in the regular course of a business's operations for cash and is generally owned for its role in contributing to the business's ability to generate profit. Furthermore, it is expected that the benefits gained from the asset will extend beyond a time span of one year. On a business's balance sheet, capital assets are represented by the property, plant and equipment figure. Examples include land, buildings, machinery, etc. Generally, these are assets that cannot quickly be turned into cash and are often only liquidated in a worst-case scenario. For example, a company might look at selling a capital asset if it was looking at restructuring or the business was engaged in bankruptcy proceedings.

Depending on the business involved, capital assets may represent the majority of assets that are owned. For example, in equipment heavy operations such as oil exploration, it is not surprising to find the majority of a business's assets to be capital assets.

**market capitalization-** The total dollar market value of all of a company's outstanding shares. Market capitalization is calculated by multiplying a company's shares outstanding by the current market price of one share. The investment community uses this figure to determine a company's size, as opposed to sales or total asset figures.

Frequently referred to as "market cap."

If a company has 35 million shares outstanding, each with a market value of \$100, the company's market capitalization is \$3.5 billion (35,000,000 x \$100 per share). Company size is a basic determinant of asset allocation and risk-return parameters for stocks and stock mutual funds. The term should not be confused with a company's "capitalization," which is a financial statement term that refers to the sum of a company's shareholders' equity plus long-term debt.

The stocks of large, medium and small companies are referred to as large-cap, mid-cap, and small-cap, respectively. Investment professionals differ on their exact definitions, but the current approximate categories of market capitalization are: Large Cap: \$10 billion plus and include the companies with the largest market capitalization.

Mid Cap: \$2 billion to \$10 billion

Small Cap: Less than \$2 billion

**enterprise value-** A measure of a company's value, often used as an alternative to straightforward market capitalization. Enterprise value is calculated as market cap plus debt, minority interest and preferred shares, minus total cash and cash equivalents. Think of enterprise value as the theoretical takeover price. In the event of a buyout, an acquirer would have to take on the company's debt, but would pocket its cash. EV differs significantly from simple market capitalization in several ways, and many consider it to be a more accurate representation of a firm's value. The value of a firm's debt, for example, would need to be paid by the buyer when taking over a company, thus EV provides a much more accurate takeover valuation because it includes debt in its value calculation.

**price-to-earnings book and sales ratios-** A valuation ratio of a company's current share price compared to its per-share earnings.

Calculated as:

Market Value per Share / Earnings per Share (EPS)

For example, if a company is currently trading at \$43 a share and earnings over the last 12 months were \$1.95 per share, the P/E ratio for the stock would be 22.05 (\$43/\$1.95).

EPS is usually from the last four quarters (trailing P/E), but sometimes it can be taken from the estimates of earnings expected in the next four quarters (projected or forward P/E). A third variation uses the sum of the last two actual quarters and the estimates of the next two quarters.

Also sometimes known as "price multiple" or "earnings multiple."

**EBITDA-** An indicator of a company's financial performance which is calculated in the following EBITDA calculation:

**EBITDA = Revenue - Expenses (excluding tax, interest, depreciation and amortiz:**

EBITDA is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

**NOPAT/Net Operating Profit After Tax-** A company's potential cash earnings if its capitalization were unleveraged (that is, if it had no debt). NOPAT is frequently used in economic value added (EVA) calculations.

Calculated as:

$\text{NOPAT} = \text{Operating Income} \times (1 - \text{Tax Rate})$

NOPAT is a more accurate look at operating efficiency for leveraged companies. It does not include the tax savings many companies get because they have existing debt.

**EVA/Economic Value Added-** A measure of a company's financial performance based on the residual wealth calculated by deducting cost of capital from its operating profit (adjusted for taxes on a cash basis). (Also referred to as "economic profit".)

The formula for calculating EVA is as follows:

$= \text{Net Operating Profit After Taxes (NOPAT)} - (\text{Capital} * \text{Cost of Capital})$  This measure was devised by Stern Stewart & Co. Economic value added attempts to capture the true economic profit of a company.

**GAAP-** The common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP are imposed on companies so that investors have a minimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such things as revenue recognition, balance sheet item classification and outstanding share measurements. Companies are expected to follow GAAP rules when reporting their financial data via financial statements. If a financial statement is not prepared using GAAP principles, be very wary! That said, keep in mind that GAAP is only a set of standards. There is plenty of room within GAAP for unscrupulous accountants to distort figures. So, even when a company uses GAAP, you still need to scrutinize its financial statements.

**burn rate-** The rate at which a new company uses up its venture capital to finance overhead before generating positive cash flow from operations. In other words, it's a measure of negative cash flow. Burn rate is usually quoted in terms of cash spent per month. For example, a burn rate of 1 million would mean the company is spending 1 million per month. When the burn rate begins to exceed forecasts, or revenue fails to meet expectations, the usual recourse is to reduce the burn rate (which, in most companies, means reducing staff).