SUMMARY

Managing business finances can be hard if you’re not familiar with basic accounting. Learn these 10 basic accounting terms to increase your accounting terminology in your business.

When you’ve got a small business to run, learning basic accounting terms doesn’t land high on the ‘to do’ list. But if you want to turn that business into a thriving organization, you've got to understand some key principles. That often starts with learning basic accounting terms.

“At the beginning, most business owners have to be a ‘jack of all trades,’” says Rob Stephens, CPA, founder of CFO Perspective, a financial management firm for small businesses in Spokane, WA. “They are so busy building the business they don’t have time to learn how to be a business leader. But as they grow, taking time to learn basic accounting for small businesses can help them make better financial decisions,” he says.

These 10 accounting terms define some business accounting basics and may just give business owners the insights they need to keep their operations running smoothly. Note that this list is for informational purposes only – while helpful to learn what these terms mean and how they can affect your business, but be sure to consult with a certified accountant before making any financial decisions.

1. Cash Flow

Cash flow is a snapshot of the timing and amount of cash coming into and out of the business at any given time. It’s a calculation of all cash collected and spent on operations, investments, and financing. “It’s important to be aware of cash flow to time purchases,” says Ric Sinordo, CPA, CEO of Modern CPA Group, an accounting firm in Atlanta.

He recommends reviewing monthly and annual cash-flow statements to identify trends, set goals, and predict coming ebbs and flows. Remember, no matter how profitable you are, if you don’t have the cash to cover your expenses you will run into trouble, he warns. “The top reason companies go out of business is because they run out of cash.”

2. Cash-Flow Forecast

Comparing past cash-flow statements with projected income and expenses allows businesses to estimate the amount of money that will move through the organization in a future period. You can use that forecast to build scenarios based on new projects or investments, or to determine when to invest in the business, pay off debts, or to pay yourself, Stephens says. He suggests doing cash-flow forecasts at least once a year, and more often if cash flow is tight.

3. Marginal Cost

Marginal cost is the difference in profit you make by selling one more unit. You can find it by dividing the total cost of production by the number of products you want to make and comparing the results. "Knowing your marginal costs will help you figure out whether making more items will be profitable," Stephens says. Keep in mind that while increasing production may lower the per item cost, it may also require hiring new staff, expanding operations, or investing in new equipment, which can alter the outcome.

4. Income Statement

An income statement details the net profit a company makes in a period of time, based on all revenues minus all expenses. It is a useful benchmark for performance and understanding profit.

5. Financial Statement

A financial statement is a collection of all the reports documenting every financial transaction a company has made. It includes the balance sheet, profit and loss (P&L) or income statement, and cash-flow statements. A financial statement is a valuable tool for understanding exactly how your business is doing.

6. Gross and Net Profit

Gross profit is the profit you make after subtracting the direct cost of producing a product or service. For example, if you make candles for $6 and sell them for $10, your gross profit is $4. Net profit is the amount of income a company has left after all other expenses are paid, including salaries, rent, debt payments, phone bills, and other operating costs. "A lot of times businesspeople mistake gross profit for net profit," Sinordo warns. Understanding the difference will help you price your products or services appropriately, and ensure your business is truly profitable.

7. Balance Sheet

A balance sheet records the company's financial history under three categories:

- Assets, including property, equipment and vehicles
- Liabilities, including debts, loans and any purchases on credit
- Owner's equity, which is the value of any assets that can be claimed by the owners

8. Accrual Accounting

This accounting method tracks revenues and expenses based on when they are incurred rather than when they are paid (cash accounting). For example, if you complete work in December, invoice the work in January, but don't get paid till February, it is still reported as revenue in December. "It's much more accurate than cash accounting for assessing profitability and long-term proof of value," Stephens says. Accrual accounting is required by the IRS if your annual revenues exceed $5 million.

9. Burn Rate

Burn rate is how long you can cover your operating costs using the cash you have without turning a profit. This is an important measure for startups that are bankrolling their own business or who receive venture capital to grow the business, Stephens says. “It tells you how long you can survive until you are self-sustaining, or until you need to go looking for another round of funding.”

10. Break-Even Analysis

This is the point at which income matches expenses for the business or a specific product or service. A break-even analysis can help you understand your burn rate and understand how pricing decisions will impact your ability to achieve profitability.

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—Ric Sinordo, CEO, Modern CPA Group

It can become overwhelming to fully understand the ins and outs of your business especially if you’re unsure of what certain accounting terms mean. Knowing these basic accounting terms can help your approach to maintaining and understanding your financial records. Consider keeping a glossary of accounting definitions handy, so you can reference it when needed. With a little bit of time and effort, you can become well-versed in accounting terminology.