Some Key Terms You Should Understand

Test your knowledge. How many of these terms do you know? If you get 8 or more, congratulations! You're on your way to a high business/finance IQ.

1. P/E ratio
2. Margin
3. Valuation
4. Variance
5. EPS
6. P&L
7. Liquidity
8. KPI
9. Market cap
10. ROI

See the back side for answers.

Key Terms and Answers

P/E ratio: The price of a share of company's stock divided by its earnings per share is called a P/E (or Price/Earnings) ratio. It assesses the relationship between a stock price and earnings, giving investors a way to compare various stocks and determine whether a stock may be undervalued, fairly valued, or overvalued.

Margin: Also known as profit margin. It is calculated by dividing the profit (or income) by sales (or revenues). If your profit was $100 and your sales were $500, your margin would be .20, or 20%. It's a way to tell whether an organization is being efficient and productive in generating sales, managing costs and producing profits. There are different types of margins – for example, an operating margin is operating income divided by sales; net margin is net income divided by sales.

Valuation: An organization's total market value. The valuation for companies whose stock trades on the public stock exchanges would be the number of shares outstanding multiplied by the price of the stock. A company with 1 million shares and a stock price of $10 would have a market value of $10 million. A company whose stock is not traded publicly can also have a valuation, based on an estimate that would consider the company's growth, whether it's in an industry likely to grow, and comparable public company valuations.

Variance: Typically used to compare a budgeted amount and an actual amount. Organizations use variance analysis to determine the differences between budgeted and actual line items in order to identify potential problems and make changes.

EPS: Earnings per share. This is calculated by using a (public) company's net income (its profits after all costs have been deducted) divided by the number of outstanding shares.

P&L: Profit and loss. Another way to describe an income statement (which shows revenues, costs and profit).

Liquidity: It describes an organization's ability to pay its bills. Does it have enough cash on hand (or assets easily converted to cash) to pay its current expenses (and cover future obligations)? Liquidity is associated with a cash flow statement and cash analysis.

KPI: Key Performance Indicator. The P/E ratio is a KPI that public companies use to assess their market valuation. Net profit margin is a KPI relating to profitability. There are many KPIs – broad (like P/E and net margin) and more specific to a given industry sector. Nonprofits, too, use KPIs, like donor retention rate. Organizations identify their most important KPIs and then compare these to benchmarks or industry standards.

Market cap: Also known as market capitalization. See valuation, above. It's the total number of shares multiplied by the share price.

ROI: Return on investment. Money that's returned (or earned) on a given investment. Let's say you buy a share of share for $20; in six months, the stock is trading at $25. At that point, you've earned $5 on your investment of $20. That equates to 5/20, or .25, which is a return of 25%. This principle can be applied to situations like deciding whether it makes sense to buy a certain piece of equipment for a business; to buy a home; and to spend money on a communication/PR campaign.