What The Finance Is Going On?

A Guide To Penetrate The Secret World Of Finance And Wealth

A quick guide by

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CHAPTERS

A Plain Language Financial Glossary for Beginners

General Investing Terms

Asset

Something you own that has value — like cash, stocks, property, or a business.

Liability

Something you owe — like a loan, credit card balance, or mortgage.

Equity

Your ownership stake in something.
For a house: value minus mortgage.
For a company: shares you own.

Liquidity

How quickly and easily you can turn something into cash without losing value.
Cash = very liquid. A house = not very liquid.

Diversification

Spreading your money across different investments so one bad performer doesn't sink your whole plan.

Market & Trading Terms

Basis Points (bps)

A tiny unit used to describe percentage changes.
1 basis point = 0.01%.
So 100 bps = 1%.

Margin

Borrowing money from your broker to buy investments.
It increases your potential gains *and* your potential losses.

Margin Call

A warning from your broker that your investment has dropped too much and you need to add more money or they'll sell your investments to cover the loan.

Volatility

How much an investment's price moves up and down.
High volatility = big swings.
Low volatility = steady.

Bull Market

A period when prices are rising and investors feel optimistic.

Bear Market

A period when prices are falling and investors feel pessimistic.

Index

A collection of investments used to track a part of the market (e.g., S&P 500).
Think of it as a "scoreboard" for a group of companies.

ETF (Exchange Traded Fund)

A basket of investments you can buy like a stock.
Often used to track an index.

Mutual Fund

A professionally managed pool of money from many investors.
Unlike ETFs, they trade only once per day.

Banking & Saving Terms

APR (Annual Percentage Rate)

The yearly cost of borrowing money, including interest and fees.

APY (Annual Percentage Yield)

The yearly return on savings, including the effect of compounding.

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Compound Interest

Interest earned on your interest.
It's why starting early matters so much.

A Simple Illustration of Compound Interest

Imagine you plant a tiny money tree seed.

Year 1

You put in **£100**.
It grows **£10** in interest.
Now you have **£110**.

Year 2

Here's the magic:
You don't just earn interest on the original £100 —
you earn interest on **£110**.

So instead of £10, you earn **£11**.
Now you have **£121**.

Year 3

Interest is now earned on **£121**,
so you earn **£12.10**,
bringing you to **£133.10**.

And it keeps going — your interest earns interest, which earns more interest, and so on.

Why starting early matters

The earlier you plant the seed, the more years it has to grow on top of itself.
Even small amounts snowball into something surprisingly large when given enough time.

Principal

The original amount of money you invest or borrow.

Taxes & Retirement Terms

Capital Gains

Profit you make when you sell an investment for more than you paid.

Capital Loss

The opposite — selling for less than you paid.

Tax Deferred

You don't pay taxes now; you pay later when you withdraw (e.g., many retirement accounts).

Tax Free

You don't pay tax on the growth or withdrawals (e.g., some ISAs or Roth style accounts).

A Roth style account is a retirement account you fund with after tax money, and in return, your investments grow tax free and can be withdrawn tax free in retirement.

It's the opposite of "traditional" retirement accounts, where you get a tax break now but pay taxes later.

What "Roth style" means

A *Roth style* account isn't one specific product — it's a **tax structure**. Any account with "Roth" in the name follows the same core rules:

Key Features

- **You contribute after tax money** (you've already paid income tax on it).
- **Your investments grow tax free** — no tax on dividends, interest, or capital gains.
- **Withdrawals in retirement are tax free**, as long as rules are met.
- **No required minimum distributions** for Roth IRAs — your money can keep growing.
- **You can withdraw contributions anytime** (Roth IRA only), since you already paid tax on them.

Types of Roth style accounts

Here are the most common versions in the U.S.:

Roth Account Type	Where It's Opened	Contribution Limits	Income Limits?	Notes
Roth IRA	Individually	£7,000 (2025, under 50)	Yes	Most flexible; no RMDs.
Roth 401(k)	Through employer	£23,000 (2025)	No	Employer match goes to *traditional* side.
Roth 403(b)	Schools & nonprofits	Same as Roth 401(k)	No	Similar rules to Roth 401(k).

Why people love Roth style accounts

- **Certainty:** You lock in today's tax rate — useful if you expect to be in a higher bracket later.
- **Tax free retirement income:** Future withdrawals aren't affected by tax hikes.
- **Flexibility:** Roth IRAs allow penalty free access to contributions.
- **Long term compounding:** Tax free growth over decades can be huge.

Quick note for UK readers (like me in Edinburgh)

The UK doesn't have "Roth" accounts by name, but **Stocks & Shares ISAs** function very similarly:

- Funded with after tax money
- Tax free growth

- Tax free withdrawals

They're essentially the UK's Roth style equivalent.

Contribution Limit

The maximum amount you're allowed to put into a retirement or tax advantaged account each year.

Risk & Return Terms

Risk Tolerance

How comfortable you are with your investments going up and down.

Asset Allocation

How you divide your money between stocks, bonds, cash, etc.
It's one of the biggest drivers of long term results.

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Sharpe Ratio

A measure of how much return you're getting for the amount of risk you're taking.
Higher = better risk adjusted performance.

Here's a clean, intuitive way to picture the **Sharpe Ratio** — no jargon, just the core idea.

Simple Sharpe Ratio Example

Imagine two investments:

Investment A

- Return: **10%**
- Feels pretty bumpy (high volatility)

Investment B

- Return: **8%**
- Much smoother ride (lower volatility)

Even though A earns more, B might actually be *better* once you factor in the risk you had to endure to get those returns.

That's exactly what the **Sharpe Ratio** measures.

Illustration

Let's pretend the Sharpe Ratios come out like this:

Investment	Return	Risk (volatility)	Sharpe Ratio	Meaning
A	10%	High	**0.6**	You took a lot of risk for the return you got
B	8%	Low	**1.0**	You earned more return *per unit of risk*

Interpretation

Even though A made more money,
B gave you more reward for each unit of risk you took.
That's why **higher Sharpe = better risk adjusted performance**.

One sentence version

Sharpe Ratio tells you how much return you're getting for every unit of risk — higher means you're being rewarded more efficiently.

Drawdown

How much an investment falls from its peak before recovering.

Debt & Credit Terms

Amortization

Paying off a loan gradually through scheduled payments.

Secured Loan

A loan backed by something valuable (like a house or car).
If you don't pay, the lender can take the asset.

Unsecured Loan

A loan not backed by collateral (like most credit cards).
Usually has higher interest.

Credit Utilization

How much of your available credit you're using.
Lower is better for your credit score.

Business & Valuation Terms

Market Capitalization (Market Cap)

The total value of a company's shares.
Price per share × number of shares.

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P/E Ratio (Price to Earnings)

A quick way to see how expensive a stock is relative to its profits.

Here are two super simple, concrete examples that make the **P/E Ratio** feel intuitive — one "good value," one "expensive."

Example of a *Good* (Low) P/E Ratio

Company A

- Stock Price: **£20**
- Earnings per share (EPS): **£2**
- **P/E Ratio = 10**

What this means

Investors are paying **£10 for every £1 of profit** the company makes.
If the company is stable and growing, that can look **reasonably priced** or even **cheap**.

Think of it like buying a business for 10× its annual profit — not bad.

Example of a *Poor* (High) P/E Ratio

Company B

- Stock Price: **£60**
- Earnings per share (EPS): **£1**
- **P/E Ratio = 60**

What this means

Investors are paying **£60 for every £1 of profit**.
That's **very expensive** unless the company is expected to grow rapidly.

It's like buying a business for 60× its annual profit — you'd need a lot of future growth to justify that price.

Quick Takeaway

- Low P/E cheaper realative to earnings (could be good value)
- High P/E more expensive payment some companies make to shareholders from their

profits. (Only makes sense if growth will be strong).

- Yield – How much income an investment pays relative to it's price. Often used for bonds and dividend stock payments.

EXPANDED GLOSSARY

1. Core Money & Banking Concepts

1. Asset

Something you own that has value.
Example: Cash, a car, shares, or property.

2. Liability

Something you owe.
Example: A mortgage or credit card balance.

3. Net Worth

Your assets minus your liabilities.
Formula:
[\text{Net Worth} = \text{Assets} - \text{Liabilities}]

4. Principal

The original amount of money you borrow or invest.
Example: If you invest £1,000, that £1,000 is the principal.

5. Interest

The cost of borrowing money or the reward for saving it.
Example: A bank pays you interest on savings.

6. Compound Interest

Interest earned on both your principal and previous interest.
Simple diagram:
Year 1 → Interest
Year 2 → Interest on (Principal + Year 1 interest)

7. APR (Annual Percentage Rate)

The yearly cost of borrowing, including fees.
Example: A credit card with 19% APR.

8. APY (Annual Percentage Yield)

The yearly return on savings, including compounding.
Example: A savings account offering 4% APY.

9. Inflation

Prices rising over time, reducing purchasing power.
Example: A loaf of bread costing £1 last year and £1.10 this year.

10. Deflation

Prices falling over time.
Example: Electronics often get cheaper as technology improves.

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2. Investing Basics

11. Stock (Share/Equity)

Ownership in a company.
Example: Owning 10 shares of Apple means you own a tiny part of the company.

12. Bond

A loan you give to a government or company in exchange for interest.
Example: A 10 year government bond paying 3% annually.

13. Mutual Fund

A pooled investment managed by professionals.
Example: A global equity mutual fund.

14. ETF (Exchange Traded Fund)

A basket of investments traded like a stock.
Example: An ETF tracking the S&P 500.

15. Index

A group of investments representing a market segment.
Example: FTSE 100, S&P 500, Nikkei 225.

16. Diversification

Spreading investments to reduce risk.
Example: Holding stocks, bonds, and real estate instead of just one.

17. Portfolio

Your collection of investments.
Example: 60% stocks, 30% bonds, 10% cash.

18. Asset Allocation

How you divide your portfolio across asset types.
Example: A conservative investor might hold more bonds.

19. Volatility

How much an investment's price moves up and down.
Example: Crypto is highly volatile; government bonds are not.

20. Liquidity

How quickly you can convert something to cash.
Example: Stocks are liquid; property is not.

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3. Market Movements & Trading Terms

21. Bull Market

A period of rising prices.
Example: Global markets from 2010–2020.

22. Bear Market

A period of falling prices (typically 20%+).
Example: The 2008 financial crisis.

23. Correction

A short term drop of 10% or more.
Example: A stock falling from £100 to £90.

24. Basis Points (bps)

A unit equal to 0.01%.
Example: A rate rising 50 bps = 0.50%.

25. Margin

Borrowing money to invest.
Example: Using £5,000 of your own money and £5,000 borrowed.

26. Margin Call

A demand to add money when your investment drops too much.
Example: Your broker requires more funds to maintain your position.

27. Leverage

Using borrowed money to amplify gains or losses.
Example: 2:1 leverage doubles both gains and losses.

28. Short Selling

Betting a price will fall.
Example: Borrowing shares, selling them, then buying them back cheaper.

Here's a simple, intuitive way to explain how you can **"borrow" shares** when short selling — without getting lost in the mechanics.

How you "borrow" shares in a short sale (simple version)

Think of it like borrowing a friend's bike to sell it — planning to buy it back later at a lower price.

Step by step

1. **You borrow shares from someone who owns them**
   This is done through your broker. The original owner still sees the shares in their account — they don't feel anything.
2. **You immediately sell those borrowed shares**
   Example: You borrow 1 share of Company X and sell it for **£100**.
3. **You wait, hoping the price falls**
   If the price drops to **£60**, great.
4. **You buy the share back at the new lower price**
   You spend **£60** to repurchase the same share.
5. **You return the share to the lender**
   You give back the share you borrowed.

Your profit

You sold for £100, bought back for £60.
Profit = £40 (minus fees).

Why this is called "short selling"

You're "short" the shares — you sold something you didn't actually own, with the obligation to return it later.

Why it's risky

If the price rises instead of falls, you still have to buy the shares back — even if they now cost £150, £300, or more.
Losses can, in theory, be unlimited.

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29. Bid Price

What buyers are willing to pay.
Example: £10.00.

30. Ask Price

What sellers want.
Example: £10.05.

31. Spread

Difference between bid and ask.
Example: £10.00 vs £10.05 = £0.05 spread.

32. Market Order

Buy/sell immediately at the current price.

33. Limit Order

Buy/sell only at a specific price.
Example: "Buy at £50 or lower."

34. Stop Loss Order

Automatically sells if the price drops to a set level.
Example: Selling at £45 to limit losses.

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4. Company & Valuation Terms

35. Market Capitalization (Market Cap)

Total value of a company's shares.
Formula:
[\text{Market Cap} = \text{Share Price} \times \text{Shares Outstanding}]

36. Earnings

A company's profits.

37. Revenue

Total money a company brings in.

38. P/E Ratio (Price to Earnings)

How expensive a stock is relative to its earnings.
Example: A P/E of 20 means investors pay £20 for £1 of earnings.

39. Dividend

A payment to shareholders from profits.
Example: £0.50 per share annually.

40. Dividend Yield

Dividend as a percentage of share price.
Formula:
[\text{Yield} = \frac{\text{Dividend}}{\text{Share Price}}]

Dividend Yield Example

Company A

- Annual dividend: **£2 per share**
- Share price: **£40**

[\text{Yield} = \frac{2}{40} = 0.05 = 5%]

Meaning

For every £100 you invest, you're getting **£5 per year** in dividends.
A 5% yield is considered fairly solid.

Company B

- Annual dividend: **£1 per share**
- Share price: **£50**

[\text{Yield} = \frac{1}{50} = 0.02 = 2%]

Meaning

For every £100 invested, you get **£2 per year** in dividends.
Lower yield — not necessarily bad, but less income-focused.

Quick takeaway

Dividend Yield tells you how much cash return you get each year relative to the price you pay for the stock.

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41. EPS (Earnings Per Share)

Profit per share.
Example: £5 earnings ÷ 1 share = £5 EPS.

42. Book Value

Company value based on assets minus liabilities.

43. ROE (Return on Equity)

Profit relative to shareholder equity.
Example: 15% ROE means £0.15 profit per £1 equity.

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5. Risk & Performance Metrics

44. Risk Tolerance

How much volatility you can emotionally and financially handle.

45. Drawdown

How far an investment falls from its peak.
Example: A drop from £100 to £70 = 30% drawdown.

46. Sharpe Ratio

Return relative to risk.
Higher = better risk adjusted performance.

47. Beta

How much a stock moves relative to the market.
Example: Beta 1.2 = 20% more volatile than the market.

Here's a clear, concrete example that makes **Beta** easy to understand.

Beta Example

Company A — Beta = 1.2

This means the stock tends to move **20% more** than the overall market.

- If the market goes **up 10%**, this stock might go **up 12%**.
- If the market goes **down 10%**, this stock might go **down 12%**.

Interpretation:
It's *more volatile* than the market — a bit of a "louder" mover.

Company B — Beta = 0.7

This stock moves **30% less** than the market.

- If the market goes **up 10%**, this stock might go **up 7%**.
- If the market goes **down 10%**, this stock might go **down 7%**.

Interpretation:
It's *less volatile* — a smoother, quieter ride.

Quick takeaway

Beta tells you how sensitive a stock is to market movements.
Above 1 = more volatile.
Below 1 = less volatile.

48. Alpha

Performance above or below expectations.
Example: A fund beating its benchmark by 2% has +2% alpha.

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6. Retirement & Long Term Planning

49. Pension

A retirement income plan (varies globally).

50. Defined Benefit Plan

Pays a guaranteed income in retirement.

51. Defined Contribution Plan

You contribute money; retirement income depends on investment performance.

52. Contribution Limit

Maximum you can add to a retirement account each year.

53. Tax Deferred

You pay tax later.
Example: Traditional retirement accounts.

54. Tax Free

Growth or withdrawals are tax free.
Example: Roth style accounts, some ISAs.

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7. Taxes & Accounting

55. Capital Gain

Profit from selling an investment.
Example: Buy at £100, sell at £150 → £50 gain.

56. Capital Loss

Selling for less than you paid.

57. Realized Gain/Loss

Happens when you sell.

58. Unrealized Gain/Loss

On paper only; you haven't sold yet.

59. Withholding Tax

Tax taken before you receive income (varies by country).

60. Tax Bracket

The rate at which your last pound/dollar is taxed.

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8. Debt & Credit

61. Credit Score

A number showing how trustworthy you are as a borrower.

62. Credit Utilization

How much of your available credit you use.
Example: £500 used of £2,000 limit = 25%.

63. Amortization

Paying off a loan over time.
Example: A 30 year mortgage.

64. Secured Loan

Backed by collateral.
Example: Car loan.

65. Unsecured Loan

Not backed by collateral.
Example: Credit card.

66. Default

Failing to repay a loan.

67. Debt to Income Ratio

How much debt you have relative to income.
Formula:
[\text{DTI} = \frac{\text{Monthly Debt Payments}}{\text{Monthly Income}}]

Here's a clean, intuitive example that makes **Debt to Income Ratio (DTI)** easy to understand.

DTI Example

Person A

- **Monthly income:** £4,000
- **Monthly debt payments:** £1,000
  (e.g., car loan £300 + credit cards £200 + mortgage £500)

[\text{DTI} = \frac{1,000}{4,000} = 0.25 = 25%]

Meaning

25% of their income goes toward debt.
This is generally considered **healthy** and manageable.

Person B

- **Monthly income:** £3,000
- **Monthly debt payments:** £1,800
  (e.g., loans, credit cards, etc.)

[\text{DTI} = \frac{1,800}{3,000} = 0.60 = 60%]

Meaning

60% of their income is tied up in debt payments.
This is **high** and often a red flag for lenders.

Quick takeaway

DTI shows how much of your income is already committed to debt.
Lower = more financial breathing room.

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9. Real Estate

68. Equity (Home Equity)

Value of your home minus mortgage.

69. Appraisal

Professional estimate of property value.

70. Mortgage

A loan to buy property.

71. Fixed Rate Mortgage

Interest rate stays the same.

72. Variable/Adjustable-Rate Mortgage

Interest rate changes over time.

73. Closing Costs

Fees paid when buying property.

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10. Global & Currency Terms

74. Exchange Rate

How much one currency is worth in another.
Example: £1 = €1.15.

75. Forex (Foreign Exchange)

Trading currencies.

76. Purchasing Power Parity (PPP)

Compares cost of goods across countries.

77. Remittance

Money sent across borders, often by workers to family back in another country.

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11. Advanced Investing Terms

78. Derivative

A financial contract whose value comes from another asset.
Example: Options, futures.

Here's an uncomplicated, everyday explanation of a **Derivative** — the simplest way to grasp it.

What's a Derivative?

A **derivative** is a financial contract whose value is based on (or *derived from*) something else — like a stock, a commodity, an index, or even interest rates.

It doesn't have value on its own.
It's like a *shadow* of another asset.

Simple Example

Imagine an apple market:

- The **apple** is the real asset.
- A **contract that lets you buy apples next month at a fixed price** is a *derivative*.

The contract's value depends entirely on what apples cost in the future.

Two common types

- **Options** — a contract giving you the *right* (but not the obligation) to buy or sell an asset at a set price.
- **Futures** — a contract where both sides *must* buy or sell the asset at a set price on a future date.

Both get their value from the underlying asset (the stock, the commodity, etc.).

One sentence version

A derivative is a contract whose price moves because the price of something else moves.

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79. Option

Right (not obligation) to buy or sell at a set price.

80. Call Option

Right to buy.

81. Put Option

Right to sell.

82. Futures Contract

Agreement to buy/sell later at a set price.

83. Hedge

Reducing risk.
Example: Airlines hedge fuel prices.

84. Arbitrage

Profiting from price differences in different markets.

85. Yield Curve

Shows interest rates for different bond maturities.

86. Inverted Yield Curve

Short term rates higher than long term — often a recession signal.

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12. Personal Finance & Behaviour

87. Emergency Fund

Savings for unexpected expenses (often 3–6 months of costs).

88. Pay Yourself First

Saving before spending.

89. Sinking Fund

Saving gradually for a known future expense.
Example: Holiday fund.

90. Lifestyle Inflation

Spending more as you earn more.

91. Opportunity Cost

What you give up when choosing one option over another.

Here’s a clear, relatable example that makes **Opportunity Cost** instantly click.

Opportunity Cost Example

Scenario

You have **£50** and two choices for your Saturday:

1. **Go out for dinner**
2. **Buy a new book you've been wanting**

You choose **dinner**.

Opportunity Cost

The **opportunity cost** of choosing dinner is:
the book you can no longer buy.

You gave up the next best alternative.

Another everyday example

You spend **2 hours** watching TV.
The opportunity cost might be:

- the workout you didn't do
- the friend you didn't meet
- the project you didn't start

It's not just about money — it's about **what you sacrifice** when you choose one option over another.

One sentence version

Opportunity cost is the value of the best thing you had to give up to choose something else.

In this context could you have bought a self help book that would give you better skills for financial management. Or instead of watching mindless television you could listen to a podcast from a finacial 'guru' to help transform your money situation.

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92. Time Horizon

How long you plan to invest.

93. Dollar Cost Averaging (DCA)

Investing a fixed amount regularly regardless of price.

94. Rebalancing

Adjusting your portfolio back to target allocations.

95. FIRE (Financial Independence, Retire Early)

A movement focused on high savings and early retirement.

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13. Crypto & Digital Assets (Global)

96. Cryptocurrency

Digital currency secured by cryptography.
Example: Bitcoin, Ethereum.

97. Blockchain

A decentralized digital ledger.

98. Wallet

Where crypto is stored (digital or hardware).

99. Token

A digital asset built on a blockchain.

100. Stablecoin

Crypto pegged to a stable asset like USD.

101. Gas Fees

Transaction fees on blockchain networks.

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14. Behavioural Finance

102. Loss Aversion

People fear losses more than they value gains.

103. Anchoring

Relying too heavily on the first number you see.

104. Herd Behaviour

Following what everyone else is doing.

105. Confirmation Bias

Seeking information that supports your beliefs.

How to Read a Company's Balance Sheet

Chapter 1 Beginner Friendly Lesson

A **balance sheet** is a snapshot of what a company *owns*, what it *owes*, and what's left for shareholders at a specific moment in time.
It follows a simple equation:

[\text{Assets} = \text{Liabilities} + \text{Equity}]

If you understand this equation, you understand the balance sheet.

Here's a **good** example and a **poor** example that make the balance sheet equation feel real and intuitive.

Good Example (Clear, Balanced, Makes Sense)

Company A — Simple Balance Sheet Snapshot

- **Assets:** £500,000
  (cash, equipment, inventory, etc.)
- **Liabilities:** £300,000
  (loans, accounts payable)
- **Equity:** £200,000
  (what's left for shareholders)

Check the equation

[\text{Assets} = \text{Liabilities} + \text{Equity}]

[500,000 = 300,000 + 200,000]

Everything lines up perfectly.

Meaning

The company owns £500k worth of stuff.
It owes £300k.
The remaining £200k belongs to the shareholders.

This is exactly how a balance sheet should work.

Poor Example (Numbers Don’t Add Up, Misunderstanding the Concept)

Company B — Incorrect Balance Sheet

- **Assets:** £800,000
- **Liabilities:** £100,000
- **Equity:** £900,000

Check the equation

[800,000 \neq 100,000 + 900,000]

This is impossible — the numbers don’t satisfy the basic rule.

Why it’s poor

- Equity is *not* an independent number you can just pick.
- It must be **Assets minus Liabilities**.
- If the equation doesn’t balance, the balance sheet is wrong. (If it doesn't look or feel right then ask yourself “What are they hiding?”)

Takeaway

If you understand the equation
[\text{Assets} = \text{Liabilities} + \text{Equity}]
you understand the entire logic of the balance sheet.
A good example always balances. A poor one breaks the equation.

1. Assets: What the Company Owns

Assets are split into two groups:

A. Current Assets (short term, used within 12 months)

- Cash
- Accounts receivable (customers who owe money)
- Inventory
- Short term investments

What strong companies show:

- Plenty of cash
- Customers paying on time
- Inventory that isn’t piling up

Example:
A retailer with £500M in inventory but falling sales may be struggling to sell products.

B. Non Current Assets (long term)

- Property and equipment
- Long term investments
- Intangible assets (brands, patents, goodwill (almost impossible to quantify. Maybe check out their ratings on Trustpilot, or the engagement on their social media).

What strong companies show:

- Assets that generate revenue
- Reasonable investment in equipment
- Intangibles that aren't ballooning from overpriced acquisitions

Example:
A tech company with rising intangible assets but flat revenue may have overpaid for acquisitions.

2. Liabilities: What the Company Owes

Liabilities also split into two groups:

A. Current Liabilities (due within 12 months)

- Accounts payable (bills owed to suppliers)
- Short term loans
- Taxes owed

What strong companies show:

- They can pay their bills with current assets
- Supplier payments aren't overdue
- Short term debt is manageable

Example:
If current liabilities are £800M but current assets are only £500M, the company may face liquidity pressure.

B. Long Term Liabilities

- Long term loans
- Bonds issued
- Pension obligations
- Lease liabilities

What strong companies show:

- Debt levels that match their cash flow
- Predictable repayment schedules
- No sudden spikes in borrowing

Example:
A company doubling its long term debt in one year may be masking cash flow problems.

3. Equity: What Belongs to Shareholders

Equity represents the “residual value” after debts are paid.

Includes:

- Share capital
- Retained earnings (profits kept in the business)
- Treasury stock (shares the company bought back)

What strong companies show:

- Growing retained earnings
- Stable or rising equity
- Buybacks funded by real cash, not debt

Example:
If equity is shrinking year after year, the company may be losing money or over leveraged.

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4. Key Ratios to Gauge Strength (Simple Formulas)

These ratios turn the balance sheet into insight.

A. Liquidity Ratios (Can they pay short term bills?)

1. Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Rule of thumb:
Above 1 = generally healthy
Below 1 = potential cash crunch

2. Quick Ratio (Stricter test)

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

Useful for companies with slow moving inventory.

Here are **clear, simple examples** for both liquidity ratios — one healthy and one concerning — so the concepts land immediately.

1. Current Ratio Example

Healthy Current Ratio

Company A

- Current Assets: **£300,000**

- Current Liabilities: **£150,000**

$$\text{Current Ratio} = \frac{300,000}{150,000} = 2.0$$

Meaning:
They have **£2 of short term assets for every £1 of short term debt**.
Plenty of cushion — generally healthy.

Weak Current Ratio

Company B

- Current Assets: **£80,000**
- Current Liabilities: **£100,000**

$$\text{Current Ratio} = \frac{80,000}{100,000} = 0.8$$

Meaning:
They don't have enough liquid resources to cover upcoming bills.
Potential cash flow stress.

---

2. Quick Ratio Example (Stricter Test)

(Removes inventory because it's harder to turn into cash quickly.)

Healthy Quick Ratio

Company C

- Current Assets: £200,000
- Inventory: £50,000
- Current Liabilities: £100,000

$$\text{Quick Ratio} = \frac{200,000 - 50,000}{100,000} = 1.5$$

Meaning:
Even without selling inventory, they can comfortably pay short term obligations.

Weak Quick Ratio

Company D

- Current Assets: £150,000
- Inventory: £90,000
- Current Liabilities: £100,000

$$\text{Quick Ratio} = \frac{150,000 - 90,000}{100,000} = 0.6$$

Meaning:
Once you strip out inventory, they don't have enough liquid assets to meet near term bills.

Quick takeaway

- **Current Ratio** asks: *Can you pay your short term bills?*
- **Quick Ratio** asks: *Can you pay them even if you can't sell inventory?*

B. Debt Ratios (Is the company over leveraged?)

3. Debt to Equity

[\text{D/E} = \frac{\text{Total Debt}}{\text{Shareholder Equity}}]

High D/E = higher risk, especially in downturns.

4. Interest Coverage

[\text{Interest Coverage} = \frac{\text{Operating Profit}}{\text{Interest Expense}}]

Below 2 = danger zone
Above 5 = comfortable

Here's a clear explanation of **what "over leveraged" means**, followed by **good, simple examples** for both debt ratios.

What does "over leveraged" mean?

A company is **over leveraged** when it has **too much debt relative to its ability to pay it back**. This usually shows up as:

- High debt compared to equity
- Struggling to cover interest payments
- Vulnerability in downturns (because debt payments don't shrink when revenue does)

Think of it like someone with a big mortgage, car loan, and credit card bill — even a small drop in income becomes dangerous.

Debt to Equity (D/E) Ratio Examples

Healthy D/E

Company A

- Total Debt: **£200,000**
- Shareholder Equity: **£400,000**

[\text{D/E} = \frac{200,000}{400,000} = 0.5]

Meaning:
The company uses some debt, but equity comfortably outweighs it.
Low risk of being over leveraged.

Over leveraged D/E

Company B

- Total Debt: **£900,000**
- Shareholder Equity: **£300,000**

$$ \text{D/E} = \frac{900,000}{300,000} = 3.0 $$

Meaning:
They have **three times more debt than equity**.
This is a classic sign of being **over leveraged** — especially dangerous if profits fall.

C. Interest Coverage Ratio Examples

Comfortable Interest Coverage

Company C

- Operating Profit: **£600,000**
- Interest Expense: **£100,000**

$$ \text{Interest Coverage} = \frac{600,000}{100,000} = 6 $$

Meaning:
They earn **6× more than needed** to cover interest.
Very safe — lenders love this.

Danger Zone (Over leveraged)

Company D

- Operating Profit: **£150,000**
- Interest Expense: **£100,000**

$$ \text{Interest Coverage} = \frac{150,000}{100,000} = 1.5 $$

Meaning:
They barely cover interest payments.
Below 2 is the **danger zone** — one bad quarter and they may not meet obligations.

Quick takeaway

- **High D/E** → company relies heavily on debt → more fragile.
- **Low Interest Coverage** → company struggles to pay interest → red flag.
- **Over leveraged** = too much debt + too little cushion.

D. Efficiency Ratios (How well do they use assets?)

5. Inventory Turnover

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Low turnover = inventory piling up
High turnover = efficient operations

Here are **two clean examples** of Inventory Turnover — one good, one poor — so the concept is unmistakable.

Good Example (High Turnover = Efficient)

Company A — Strong Inventory Turnover

- **Cost of Goods Sold (COGS):** £600,000
- **Average Inventory:** £100,000

$$\text{Inventory Turnover} = \frac{600,000}{100,000} = 6$$

Meaning

They sell through their inventory **6 times per year**.
This suggests:

- Products are moving quickly
- Less cash is tied up in stock
- Lower risk of items becoming obsolete

This is what efficient operations look like.

Poor Example (Low Turnover = Inventory Piling Up)

Company B — Weak Inventory Turnover

- **Cost of Goods Sold (COGS):** £300,000
- **Average Inventory:** £200,000

$$\text{Inventory Turnover} = \frac{300,000}{200,000} = 1.5$$

Meaning

They only sell through inventory **1.5 times per year**.
This suggests:

- Stock is sitting on shelves
- Cash is tied up and not productive
- Possible over ordering or weak demand

A classic sign of operational inefficiency.

Quick takeaway

High turnover = inventory moves fast = efficient.
Low turnover = inventory sits around = potential trouble.

---

5. Red Flags to Watch Out For

Here's the part readers love — the "danger signs."

A. Weak Liquidity

- Current ratio below 1
- Cash falling while short-term debt rises
- Receivables growing faster than revenue (customers not paying)

B. Excessive Debt

- Rapid increase in long term borrowing
- Interest coverage falling
- Debt used to fund dividends or buybacks

C. Bloated Intangibles

- Goodwill rising sharply after acquisitions
- Impairments (write downs) appearing frequently
  This often signals the company overpaid for acquisitions.

D. Inventory Problems

- Inventory rising faster than sales
- Low inventory turnover
  This can indicate slowing demand or poor management.

E. Negative Equity

If liabilities exceed assets, equity becomes negative.
This is rare but a major warning sign.

F. Frequent "one time" charges

If a company reports "one time" losses every year, they're not one time.

6. A Simple 5 Minute Balance Sheet Checklist

You can use this as a quick diagnostic:

1. **Is cash stable or growing?**
2. **Are current assets comfortably above current liabilities?**
3. **Is debt rising faster than profits?**
4. **Are intangibles growing suspiciously fast?**
5. **Is equity stable or increasing?**
6. **Do ratios show liquidity and solvency?**
7. **Any red flags in notes (lawsuits, pension deficits, write downs)?**

If most answers look healthy, the company is likely financially sound.

Chapter 2: How to Read a Company's Balance Sheet- Deeper Dive

A balance sheet provides a snapshot of a company's financial position at a specific point in time. It shows what the company owns, what it owes, and the value that belongs to shareholders. Understanding this document allows investors to assess financial strength, identify risks, and compare companies across industries and countries.

1. The Balance Sheet Equation

Every balance sheet is built on a single formula:

[\textbf{Assets = Liabilities + Equity}]

This equation must always balance.
A simple diagram illustrates the structure:

```
+------------------------------+
|            Assets            |
| (What the company owns)      |
+------------------------------+
| Liabilities |     Equity     |
| (Owed)      | (Owned by      |
|             | shareholders)  |
+------------------------------+
```

2. Assets: What the Company Owns

Assets represent resources that generate future economic value. They are divided into **current** and **non current** categories.

2.1 Current Assets (expected to convert to cash within 12 months)

Typical items include:

- Cash and cash equivalents
- Accounts receivable
- Inventory
- Short term investments
- Prepaid expenses

What strong companies show:

- Sufficient cash to operate
- Customers paying on time
- Inventory levels aligned with sales

Example:
A manufacturer with rising inventory but flat sales may be overproducing or facing weakening demand.

2.2 Non Current Assets (long term resources)

These include:

- Property, plant, and equipment
- Long term investments
- Intangible assets (patents, brands, goodwill)

What strong companies show:

- Productive assets that support revenue
- Intangibles that reflect genuine competitive advantages
- Stable or improving asset efficiency

Example:
A company with rapidly increasing goodwill may be overpaying for acquisitions.

3. Liabilities: What the Company Owes

Liabilities represent obligations the company must settle in the future.

3.1 Current Liabilities (due within 12 months)

Common items:

- Accounts payable
- Short term loans
- Taxes payable
- Current portion of long term debt

What strong companies show:

- Ability to cover short term obligations with current assets
- Stable supplier relationships
- Manageable short term borrowing

Example:
If current liabilities exceed current assets, the company may face liquidity pressure.

3.2 Long Term Liabilities

These include:

- Long term loans and bonds
- Lease obligations
- Pension liabilities
- Deferred tax liabilities

What strong companies show:

- Debt levels aligned with cash flow generation
- Predictable repayment schedules
- No sudden spikes in borrowing

Example:
A company doubling its long term debt in one year may be masking operational weakness.

4. Equity: The Shareholders' Claim

Equity represents the residual value after liabilities are deducted from assets.

Key components:

- Share capital
- Retained earnings
- Treasury stock
- Other reserves

A simplified diagram:

```
Equity =
  Share Capital
+ Retained Earnings
- Treasury Shares
+ Other Reserves
```

What strong companies show:

- Growing retained earnings
- Stable or rising equity
- Share buybacks funded by real cash, not debt

Example:
Declining equity over several years may indicate persistent losses or excessive leverage.

---

5. Key Ratios for Assessing Financial Strength

Ratios convert raw numbers into meaningful insights. The following are essential for evaluating balance sheet health.

5.1 Liquidity Ratios

Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Indicates the ability to meet short term obligations.

Quick Ratio

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

A stricter measure that excludes inventory.

5.2 Solvency Ratios

Debt to Equity

$$\text{D/E} = \frac{\text{Total Debt}}{\text{Shareholder Equity}}$$

Shows how much the company relies on borrowing.

Interest Coverage

$$\text{Interest Coverage} = \frac{\text{Operating Profit}}{\text{Interest Expense}}$$

Measures the ability to service debt.

5.3 Efficiency Ratios

Inventory Turnover

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Indicates how efficiently inventory is sold.

Receivables Turnover

$$\text{Receivables Turnover} = \frac{\text{Revenue}}{\text{Average Accounts Receivable}}$$

Shows how quickly customers pay.

6. Interpreting the Balance Sheet: Strengths and Weaknesses

A balance sheet reveals patterns that signal financial health or potential trouble.

6.1 Signs of Strength

- Consistent cash reserves

- Current assets comfortably exceeding current liabilities
- Moderate, well structured long term debt
- Growing retained earnings
- Stable or improving equity
- Efficient use of assets (high turnover ratios)

6.2 Warning Signs

- Current ratio below 1
- Rapid increase in short term borrowing
- Rising receivables without matching revenue growth
- Inventory accumulating faster than sales
- Large or growing goodwill from acquisitions
- Declining equity
- Frequent write downs or impairments
- Interest coverage falling toward 1 or below

7. A Practical 5 Step Review Method

You can use this method to evaluate any company quickly.

Step 1: Check liquidity

Is there enough cash and current assets to cover short-term obligations?

Step 2: Examine debt levels

Is debt rising faster than earnings or cash flow?

Step 3: Review asset quality

Are assets productive, or are intangibles and inventory ballooning?

Step 4: Assess equity trends

Is shareholder value growing or shrinking?

Step 5: Scan for red flags

Look for sudden changes, unusual items, or repeated “one time” charges.

8. Summary Diagram: Balance Sheet Health at a Glance

BALANCE SHEET HEALTH CHECK

```
+-----------------------------------------------------------+
| Liquidity   | Current ratio > 1? Cash stable?             |
```

Debt	Debt manageable? Interest coverage strong?
Assets	Inventory aligned with sales?
Equity	Retained earnings growing?
Red Flags	Write-downs? Rising goodwill?
+----------+----------+

SECTION: HOW TO READ FINANCIAL STATEMENTS

This section provides a clear, practical framework for understanding the three core financial statements used worldwide: the **Balance Sheet**, the **Income Statement**, and the **Cash Flow Statement**. Together, these documents reveal a company's financial strength, profitability, and ability to generate cash.

CHAPTER 3: The Income Statement

The income statement (also called the profit and loss statement) shows a company's performance over a period — typically a quarter or a year. It answers the question: **Did the company make money?**

1.1 Structure of the Income Statement

Revenue = Cost of Goods Sold = Gross Profit
Net Profit = Gross Profit - Operating Expenses – Interest - Taxes

1.2 Key Components

Revenue

Total income from goods or services sold.

Cost of Goods Sold (COGS)

Direct costs of producing goods or services.

Gross Profit

[Revenue - COGS]

Operating Expenses

Costs of running the business (marketing, admin, salaries).

Operating Profit (EBIT)

Earnings before interest and taxes.

Net Profit

Final profit after all expenses.

1.3 Profitability Ratios

Gross Margin

[\frac{\text{Gross Profit}}{\text{Revenue}}]

Operating Margin

[\frac{\text{Operating Profit}}{\text{Revenue}}]

Net Margin

[\frac{\text{Net Profit}}{\text{Revenue}}]

EXAMPLES

1. Gross Margin

Formula:
[\frac{\text{Gross Profit}}{\text{Revenue}}]

Example

- Revenue: £500,000
- Cost of Goods Sold (COGS): £300,000
- Gross Profit: £200,000

[\text{Gross Margin} = \frac{200,000}{500,000} = 0.40]

Gross Margin = 40%
This means the company keeps 40p of every £1 of revenue after covering direct production costs.

2. Operating Margin

Formula:
[\frac{\text{Operating Profit}}{\text{Revenue}}]

Example

- Revenue: £500,000
- Operating Expenses (admin, marketing, wages): £150,000
- Gross Profit: £200,000
- Operating Profit: £50,000

[\text{Operating Margin} = \frac{50,000}{500,000} = 0.10]

Operating Margin = 10%
This shows the company keeps 10p of every £1 after paying for all operating costs but before

interest and taxes.

3. Net Margin

Formula:
[\frac{\text{Net Profit}}{\text{Revenue}}]

Example

- Revenue: £500,000
- Operating Profit: £50,000
- Interest + Taxes: £20,000
- Net Profit: £30,000

[\text{Net Margin} = \frac{30,000}{500,000} = 0.06]

Net Margin = 6%
This tells us the company ultimately keeps 6p of every £1 after *all* expenses.

Quick Comparison Table

Ratio	What It Shows	Example Result
Gross Margin	Core production efficiency	**40%**
Operating Margin	Efficiency of running the business	**10%**
Net Margin	Final profitability after everything	**6%**

1.4 What to Watch For

- Revenue growing slower than competitors
- Falling margins
- Rising operating expenses without revenue growth
- Large “one time” charges appearing frequently
- High interest expense eating into profits

CHAPTER 4: The Cash Flow Statement

The cash flow statement shows how much cash a company generates and where it goes. It is divided into three sections.

4.1 Structure of the Cash Flow Statement

Cash Flow from Operating Activities
+ Cash Flow from Investing Activities
+ Cash Flow from Financing Activities
= Net Change in Cash

4.2 Operating Cash Flow (OCF)

Cash generated from core business operations.
A strong company consistently produces positive OCF.

4.3 Investing Cash Flow (ICF)

Cash used for long term investments.
Examples: buying equipment, acquiring businesses.

Negative ICF is normal for growing companies.

4.4 Financing Cash Flow (FCF)

Cash from borrowing, repaying debt, issuing shares, or paying dividends.

4.5 Free Cash Flow (FCF)

[\text{Free Cash Flow} = \text{Operating Cash Flow} - \text{Capital Expenditures}]

Free cash flow is one of the most important indicators of financial health.

4.6 What to Watch For

- Net profit rising while operating cash flow falls
- Repeated borrowing to fund dividends or buybacks
- Large negative cash flows from operations
- Capital expenditures far exceeding cash generation

CHAPTER 5: How the Three Statements Work Together

Financial statements are interconnected. Understanding their relationships provides deeper insight.

5.1 The Flow of Information

Income Statement → Net Profit
Net Profit → Equity (via Retained Earnings)
Equity → Balance Sheet
Operating Profit → Cash Flow Statement

5.2 Example Flow

1. A company earns profit → increases retained earnings
2. Retained earnings increase equity → strengthens balance sheet
3. Profit also contributes to operating cash flow → improves liquidity

If profit is high but cash flow is low, the company may have collection issues or accounting issues.

CHAPTER 6: A Practical Framework for Analysis

This chapter provides a step by step method for evaluating any company using all three statements.

6.1 Step 1: Assess Liquidity

- Current ratio
- Quick ratio
- Cash levels

6.2 Step 2: Evaluate Profitability

- Gross, operating, and net margins
- Return on equity (ROE)
- Return on assets (ROA)

6.3 Step 3: Examine Cash Generation

- Operating cash flow
- Free cash flow
- Cash conversion cycle

6.4 Step 4: Review Leverage

- Debt to equity
- Interest coverage
- Debt maturity schedule

6.5 Step 5: Identify Red Flags

- Rising receivables without revenue growth
- Inventory buildup
- Frequent write-downs
- Negative free cash flow over multiple years
- Debt funded dividends or buybacks

CHAPTER 7: Summary Diagrams

5.1 The Three Statements at a Glance

BALANCE SHEET
Snapshot of financial position
Assets = Liabilities + Equity

INCOME STATEMENT
Performance over time

Revenue → Profit

CASH FLOW STATEMENT
Cash in and out
Operating / Investing / Financing

5.2 The Investor's Checklist

Liquidity	Can the company pay its bills?
Profitability	Are margins stable or rising?
Cash Flow	Is the business generating cash?
Leverage	Is debt manageable?
Red Flags	Any unusual patterns?