



### **Off the books**

'Off the books' is a term associated with transactions which do not appear in any of the financial records kept by a business. Strictly speaking, 'off the books' implies cash payments received for **assets** (products and services) which are not officially recorded in the accounting system of the business.

### **Off balance sheet financing**

This is a form of borrowing in which the obligation is not recorded on the borrower's **financial statements**. Off balance sheet financing can employ several different techniques, which include development arrangements, leasing, product financing arrangements or recourse sales of receivables. Off balance sheet financing does raise concerns regarding the lenders' overall risk, but it improves their **debt to equity ratio**, which enhances their borrowing capacity. As a result, loans are often easy to arrange and are given lower interest rates because of the improved debt structure on the **balance sheet**. Off balance sheet financing is a technique often used by multinational businesses in order to secure additional loans on the worldwide loan market.

Ketz, J. Edward, *Hidden Financial Risk: Understanding Off Balance Sheet Accounting*. New York: John Wiley, 2003.

### **Offshore banking unit**

An offshore banking unit is an entity which acts as an intermediary in financial transactions between non-resident borrowers and lenders. Offshore banking units are normally foreign banks which conduct business in the domestic money market. They can deal in foreign exchange settlements and in **Eurocurrencies**, for example. Offshore banking units cannot accept domestic deposits and their activities are unrestricted by domestic authorities. Offshore banking units tend to be located in major financial centres, which are often known as offshore

banking centres. Normally these financial centres have fairly liberal tax and capital market requirements.

Typical offshore banking activities include:

- borrowing or lending;
- making guarantees;
- trading;
- contracting;
- investment;
- advisory work;
- hedging.

Schneider, Jerome, *The Complete Guide to Offshore Money Havens*. New York: Prima Lifestyles, 2001.

### **Omitted dividend**

An omitted dividend, as the term implies, is the non-payment of an expected dividend. The dividend is usually unpaid as a result of the business finding itself in financial difficulties. Omitted dividends tend to be regularly scheduled dividends.

### **One-time charge**

One-time charges relate to single, one-off expenses incurred by a business, which it does not expect to have to allow for in a future accounting period. One-time charges could include the payment of additional taxes, redundancy payments, or the acquisition of new assets which were not expected. Typically, the business will seek to assure its **shareholders** that the one-time charge will not be a recurring theme.

### **Operating asset**

An operating asset is seen to be an asset owned by the business which makes a positive contribution to the output and hence the revenue of the business. Typical forms of operating assets could include plant and machinery and, in some cases, assets such as the delivery and transportation fleet which ensures customers' supply.

### **Operating budget**

A business's operating budget is, essentially, a forecast of its future financial needs. The operating budget may cover a range of different



time periods into the future, but typically will cover the forthcoming year.

The operating budget will include not only estimates of the financial requirements, but also the expected revenue streaming into the business, which will (ultimately) fund the operations. The operating budget will, therefore, incorporate sales, production and **cash flow**.

It is the function of managers and accountancy personnel to monitor the relationship between the operating budget and the actual figures being produced, as they occur. Changes or divergent figures are monitored, assessed and adjusted as required.

### Operating cash flow

The operating cash flow of a business relates to the money moving in and out of the organization which is directly related to its operations, rather than any other form of movement, including financial transactions. Typically, the following formula is used to calculate the operating cash flow for business:

$$\text{Net profit} + \text{accrual change} + \text{change in accounts payable (expenditure)} - \text{accounts receivable (receipts)} - \text{changes in inventory (stock levels)}$$

Reider, Rob and Heyler, Peter B., *Managing Cash Flow: An Operational Focus*. New York: John Wiley, 2003.

### Operating costs

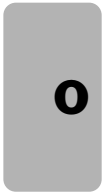
Typically, operating costs refer to a costing system which is applied to the number of units produced over a period of time. The operating costs are calculated by identifying the costs incurred over the period in relation to the number of units produced. The calculation is:

$$\frac{\text{Total operating costs}}{\text{Number of units produced}}$$

This figure reveals the average unit cost for the period of time in question.

Alternatively, operating costs may refer to other costs not directly associated with production. In this case, 'operating costs' refers to the day-by-day expenses of the business in relation to such items as administration, marketing or sales.

Harrop, David and McGladrey, R. S. M., *Controlling Operating Costs*. Arlington, VA: A. S. Pratt & Sons, 1997.



## Operating cycle

The 'operating cycle' refers to the following process, typical in many businesses:

- funds are used to purchase raw materials, components or products;
- funds are used to convert, process, distribute or otherwise hold and deliver those items;
- funds are received by the sale of those items.

More specifically, the operating cycle can also refer to the average time taken between the following:

- purchasing/acquiring;
- receiving cash from sale.

## Operating income

'Operating income' refers to the amount of funds which a business has received from its operational activities. Operating income is variously known as **operating profit** or EBIT (earnings before interest and tax).

At its simplest, operating income is equal to:

$$\text{Revenue received (from operations)} - \frac{\text{cost of goods sold and operating expenses}}$$

In this case 'operating expenses' refers to the normal expenditure directly attributable to operations.

## Operating leverage (gearing)

Operating leverage is a measure which seeks to investigate the relationship between the fixed operating costs and the total operating costs. The normal equation used is:

$$\frac{\text{Fixed operating costs}}{\text{Total operating costs}}$$

In this sense total operating costs include both fixed and variable operating costs.

## Operating margin

Typically, the operating margin of a business is calculated by:

$$\frac{\text{Operating income}}{\text{Revenue}} \times 100$$



In effect, the operating margin is another means by which the **profit margin** can be calculated.

### Operating profit

An operating profit, or indeed an operating loss, is calculated by looking at the total trading activity of a business. The operating profit is calculated by deducting the operating expenses from the trading profit, or adding operating expenses to a trading loss, excluding any extraordinary or exceptional items which may otherwise distort the appreciation of the business. All calculations are made before interest.

### Operating rate

The operating rate of a business is a measure of the percentage of its total production capacity which is currently being used. In other words, the operating rate is a means by which the utilization of the production facilities can be assessed, illustrating whether or not the output is close to an optimum level.

*See also capacity utilization rate.*

### Operating ratio

The simplest form of operating ratio addresses the relationship between a business's operating expenses and its operating revenues:

$$\text{Operating ratio} = \frac{\text{Operating expenses}}{\text{Operating revenue}}$$

In reality, however, the operating ratio can be a number of different calculations and comparisons, including:

- sales to **cost of goods sold**;
- **net profits** to gross income;
- **net profits** to **net worth**.

All of these equations offer an insight into the relationships between revenue and expenditure, or profit and perceived market value.

### Operational gearing

Operational gearing seeks to measure the relationship between a business's fixed costs and output. In cases where a business has high **fixed costs** as a proportion of its **total costs**, the business is deemed to have

a high level of operational gearing. Potentially this could cause the business problems in as much as it is reliant on the fact that demand continues to remain buoyant. If there is a fall in demand, then the revenues of the business will fall, thereby making the proportion of fixed costs to revenue (or output) even greater. In this way, the business can foresee a series of situations which may turn its profits into serious losses.

Normally, businesses cannot themselves do a great deal about the operational gearing, largely on account of the fact that it may be typical and necessary in the industry in which they operate. An industry which continues to suffer from high levels of operational gearing is the airline business. Airlines have extremely high operational gearing costs and are prone to huge losses should demand for flights fall away. This was a particular case after the attacks on New York and Washington in September 2001.

### Opportunity cost

'Opportunity cost', although strictly speaking an economics term, can be equally applied to accounting, marketing and advertising. Each time a business chooses to pursue a particular form of activity, it has made that choice after having investigated all of the other options. Given the fact that it is unlikely, even with the largest budget available, that a business can pursue all forms of activities simultaneously, some options have to be discarded. 'Opportunity cost' argues that the potential benefits which could have been enjoyed by choosing a particular activity have to be considered if they are not chosen and an alternative action is preferred. In other words, opportunity cost examines the real cost of an action in terms of the next best alternative that has been forgone.

Buchanan, James M., *The Cost and Choice: An Inquiry in Economic Theory*. Indianapolis, IN: Liberty Fund, 2000.

Heymann, H. G. and Bloom, Robert, *Opportunity Cost in Finance and Accounting*. Westport, CT: Greenwood Press, 1990.

### Option

An option is the right to buy or sell a specific quantity of a currency, security or commodity at a specific price on a named date.

The purchaser of the option is not bound to either buy or sell at what is known as the exercise price, which is the price it is traded at. The purchaser may simply decide to allow the option to lapse, in which case any premium that was paid is lost.

The actual option to buy is known as a call option and the option to



sell is known as a put option. Call options are usually purchased when an investor predicts that prices will rise, and a put option when prices are expected to fall.

Normally investors will hedge with their investments in order to offset the dangers of wildly fluctuating prices. Therefore, investors take out options on numerous investments to cover potentially exposed positions.

Kaepfel, Jay, *The Four Biggest Mistakes in Option Trading*. Colombia, MD: Traders Library, 1998.

Natenberg, Sheldon, *Option Volatility and Pricing: Advanced Trading Strategies and Techniques*. London: Irwin Professional, 1994.

### Optional dividend

An optional dividend offers the **shareholder** the opportunity either to take the regular **dividend** payment in cash (which has tax implications) or to take the dividend payment in the form of additional stocks (or shares), which is a more tax-efficient option. The value of the optional dividend choice is clearly related to the intentions of the investors and whether they are seeking income generation (from cash dividends) or capital growth (in the form of extra shares).

### Ordinary share/shareholders

An ordinary share is a fixed unit of share capital of a business which is a publicly quoted organization whose shares are traded on the stock exchange. Ordinary shares yield a dividend on the capital that was invested in the purchase of the share. These dividends represent a proportion of the profits made by the business. Many investors purchase shares for longer-term rewards, taking the gamble that whilst they receive dividends throughout their ownership period, at some point in the future the shares will be worth considerably more than the price they paid for them at the beginning of their investment. Ordinary **shareholders** are the last investors in the business to receive any return in cases where the business goes into **liquidation**. **Preference shareholders**, creditors and government agencies, including the Inland Revenue, all have their outstanding debts settled before ordinary shareholders. This makes ordinary shares a higher risk, yet they enjoy the benefits of the business should it prove to be successful.

### Original cost

In accounting terms, original cost refers to all expenses associated with the acquisition of an asset. These total costs may include the disposal of

**fully depreciated** assets which the new asset will replace, installation, maintenance and support costs, and delivery and training implications.

### **Other current assets**

This is a term associated with the **balance sheet** of a business. Other current assets refer to non-cash assets which are expected to mature within the coming year.

### **Other long-term liabilities**

This is a term associated with the **balance sheet** of a business. 'Other long-term liabilities' refers to financial obligations of the business which do not attract the requirement to pay interest in the coming year. Other long-term liabilities can include:

- value of leases;
- employee benefits;
- deferred taxation.

### **Outgo**

'Outgo' is a shortened version of the term 'out-goings', i.e. expenses.

### **Outlay**

'Outlay' is another term used to describe a business's expenditure.

### **Outsourcing**

Outsourcing is gradually gaining ground as a primary means by which the functions related to employees are handled by a business. There have been significant changes in policy where a shift has been in progress from providing services in-house to using external organizations. In effect, outsourcing is the use of another organization or an agency for some, or all, of the business's functions.

Outsourcing is not only restricted to smaller businesses; for example, a business that has grown significantly over recent years has a greater tendency to consider outsourcing, largely as it prefers to focus on the operations of the core business, and there is a culture of outsourcing which has enhanced the growth. For example, in the USA where there is a strong tradition of outsourcing human resources functions, this industry was worth an estimated \$13.9 billion in 1999, and according to research businesses such as Dataquest, it will reach \$37.7 billion in 2004.



Outsourcing falls into four broad categories:

- Professional Employer Organizations (PEO) take on all of the responsibilities of the human resource administration for a business, including the legal responsibilities and the hiring and dismissal of employees. Typically, the relationship is co-operative, with the PEO handling human resources and the business itself dealing with all other aspects of operations. Not all PEOs take the full responsibility for human resources, some merely handling payroll and benefits systems.
- Business Process Outsourcing (BPO), although a general term used to describe outsourcing in the broadest sense, refers to human resources in respect of supporting the human resource functions with technology and software (including data warehousing and other services).
- Application Service Providers (ASPs) restrict their relationship with a business to providing either web-based or customized software to help manage human resource functions such as payroll and benefits.
- E-services can be either ASPs or BPOs, which again are restricted in the relationship to web-based services such as recruitment, software and data warehousing or other forms of data storage and access provision for human resources departments.

Incomes Data Services, *Outsourcing HR Administration*. London: Income Data Services, 2000.

Vanson, Sally, *The Challenge of Outsourcing Human Resources*. Oxford: Chandos Publishing, 2001.

### Overbought

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The term 'overbought' has three associated finance and accounting applications. One of the simplest definitions relates to a business purchasing more components, raw materials or finished goods than it actually needs in order to fulfil the orders it has.

The second definition relates to the purchasing of more commodities and securities than are covered by the margins which have been deposited with a dealer or a broker.

The third finance-related definition refers to a market which has rapidly risen due to a high volume of purchases. In reality, the market may be somewhat unstable and may well fall at any time in the near future.

### Overcapacity

Overcapacity in a market occurs when the supply (or output or capacity) of the suppliers in that market is in excess of the current, or for that matter, the anticipated demand levels in that market.

The financial implications are that demand may fall beneath the **breakeven point** of certain businesses. This may mean that some or all of the following could occur:

- The weaker producers with a more vulnerable breakeven point may be forced into liquidation.
- The producers may attempt to reduce their overheads and attempt to downsize or rationalize their operations.
- In order to stimulate demand, the producers may reason that a drop in prices might well be the only alternative for the short to medium term.

### Overcapitalization

Overcapitalization occurs when a business finds itself in a position of simply having more cash (capital) than it needs in order to operate. Normally an overcapitalized business suffers from one of the following problems:

- It may have a high burden in respect of interest charges;
- It may have to distribute its profits to a great many **shareholders** through dividend payments.

The standard approach to dealing with overcapitalized situations is to either:

- Pay off the long-term loans and other debts to reduce the interest payments.
- Purchase shares back from the shareholders to enable the business to retain its own profits for reinvestment.

### Overdraft

Technically, this term refers to the amount by which a bank account has seen withdrawals exceed the actual balance of the account.

Overdrafts are designed as a form of short-term credit, allowing a business to temporarily (if frequently) withdraw sums in excess of the balance of cash held in the account. Typically, the level of overdraft is set by mutual consent after the business requests the facility from its

bank. Varying rates of interest are paid to the bank for accounts which are overdrawn depending on arrangements.

### Overhead

Overheads are costs generated by a business that are not directly related to the production process. Many businesses refer to overheads as either **fixed costs** or **indirect costs** as they include costs related to the ownership and maintenance of the property in which the business operates, for example, heating, lighting, and administrative costs.

Booth, Rupert, *Control your Overheads: A Practical Programme to Improve Performance and Reduce Costs*. London: Financial Times, Prentice-Hall, 1994.

### Overhead ratio

The overhead ratio shows the proportion of expenditure, in relation to the business's total income, which cannot be directly attributed to the production or delivery of products or services.

Typically, the overhead ratio is calculated using the following equation:

$$\frac{\text{Operating expenses}}{\text{Total net interest income} + \text{operating income}}$$

A business's operating expenses include:

- rent or lease payments;
- maintenance;
- **depreciation.**

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### Overinvestment

Overinvestment implies somewhat too much capital investment. It is a frequent factor which occurs in manufacturing industries. The process usually occurs towards the end of a boom period which has seen a sustained level of demand for products and which had been steeply growing over a period of time. The investment takes place just as the boom is beginning to falter, in the hope that the boom will remain and that demand will continue to increase.

Gradually, or in some cases abruptly, the boom terminates, leaving the manufacturing industry with overproduction. In other words, they are geared up to produce more capacity than the market needs. Investment ends equally as abruptly and employees are laid off,

which only serves to deepen the problems of the forthcoming recession period.

### **Oversubscription**

Oversubscription occurs when there is an excess demand for newly issued shares. Under the terms of most businesses, the applications are all scaled down. In other cases, the business may decide to allocate shares by a ballot system (this has to have been announced as the method chosen before the share issue).

Oversubscription usually occurs when the business has set the share price too low; the low value having been decided on to ensure that the shares are taken up. In these cases, there has been a miscalculation in respect of the demand that would be generated by the low price. Clearly, businesses would not wish to be in a position where the shares have not all been sold and the maximum capital injection has not been achieved.

*See also undersubscription.*

### **Overtrading**

Overtrading occurs when a business enters into commitments or transactions which are in excess of its available short-term resources. In other words, it has taken on commitments which, under current circumstances, it will find impossible to complete. Overtrading can occur even when a business is trading profitably, and in most cases overtrading takes place when there are financial strains on the business which are imposed by lengthy production cycles. The net effect of overtrading is to render the business incapable of continuing its operations, as it has overcommitted its resources and will find it impossible to meet those commitments.

### **Owner's equity**

'Owner's equity' is another term used to describe **net worth**, **shareholder's equity** or **net assets**. It is calculated using the following equation:

$$\text{Total assets} - \text{total liabilities}$$

*See also capital net worth.*

