GLOSSARY

A

ABC System A system of controlling inventory that recognizes the differing cost and importance of various items. A parts are expensive and/or important and are controlled carefully. C parts are cheap and plentiful, so little effort is expended to monitor them. B parts are between As and Cs.

Accelerated Depreciation Any method that shifts depreciation forward in an asset's life. Accelerated methods increase early charges and reduce those that come later, keeping total depreciation constant.

Acquisition A merger in which one company acquires the stock of another. May be friendly or hostile (unfriendly). See *Merger*.

Agency A relationship between two parties in which one (the principal) employs the other (the agent) in a decision-making capacity.

Agency Problem In corporations, managers are the agents of stockholders and are often able to take advantage of the relationship by diverting corporate resources to their own use. Excessive pay is the primary example. The general situation is described as the agency problem. Costs associated with controlling the agency problem are *agency costs*.

Amortized Debt A debt in which the principal is repaid over the life of the loan rather than in a lump sum at the end.

Annual Report A yearly report on a company's performance prepared by management. An annual report includes financial statements and generally contains verbal discussions of the firm's operations and prospects.

Annuity A finite series of equal payments at equal intervals of time. In an *ordinary annuity* the payments occur at the ends of the time periods. In an *annuity due* they occur at the beginnings.

Antitrust Law A body of legislation aimed at maintaining the competitive nature of the economy. The antitrust laws can prohibit certain mergers on the basis that they reduce competition.

Audit A process in which an organization's records, usually financial, are examined to ascertain whether they have been correctly kept and truly reflect the organization's activities. In business, accounting records are usually audited by Certified Public Accountants (CPAs).

Audit Committee A committee of the board of directors of a corporation charged with reviewing the financial records of the company and more recently the firm's relationship with its auditors.

Average Collection Period (ACP) A financial ratio that measures how long it takes to collect on credit sales. Also called *days sales outstanding* (DSO).

Average Tax Rate A taxpayer's total tax bill divided by taxable income. A composite of the various bracket rates to which the taxpayer's income is subject.

B

Backorder An order to replenish an out-of-stock item, usually on an expedited basis.

Balance of Trade The difference between imports from and exports to another country. If imports are larger a *trade deficit* exists. If exports are larger there is a *trade surplus*.

Bankruptcy A federal court procedure to protect a failing firm from its creditors until the best resolution to its problems can be found.

Basic EPS Earnings after tax divided by the number of shares outstanding during the year.

Bearer bond An unregistered bond, owned by the "bearer," the person in possession.

Beta The measure of market risk in portfolio theory. The degree to which a stock's return moves with the market's return.

Bill A security associated with very short-term debt.

Black-Scholes Option Pricing Model A viable option pricing model, developed by financial scholars Fisher Black and Myron Scholes, that gives results similar to those of stock pricing models.

Board of Directors The governing body of a corporation, elected by common stockholders.

Bond A security reflecting a relatively long-term debt relationship between the issuer (borrower) and the buyer (lender).

Bond Rating A measure of the likelihood of default on payment of interest or principal. Ratings are prepared by *rating agencies*. The best known agencies are Moody's and Standard and Poor's.

Book Value For a company, the value of equity, equal to total assets minus total liabilities. Book value can be stated in total or per share. For an asset, book value is the net of original cost minus accumulated depreciation, and is generally referred to as *net book value*.

Bottom-up Planning Business planning based on inputs from lower level management. The process tends to understate achievable performance because people set easily achievable goals for themselves.

Breakeven Analysis A technique for finding the volume at which a firm breaks even financially—that is, earns zero profit.

Broker See *Stockbroker*.

Brokerage Firm (House) A company of stockbrokers generally having the right to trade on an exchange.

Budget A short-term, financially detailed business plan, usually covering about a calendar quarter.

Business Plan A document projecting a firm's physical and financial performance into the future. Business plans can be short or long range. Long-range plans are "strategic" and tend to be more verbal than financial. Shorter-term plans are described as "operational," and detail the more routine running of the business.

Business Risk Variation in a company's financial performance caused by changes in business conditions.

Business-Specific Risk Variation in the return on a stock investment caused by things that affect specific businesses or industries.

C

Call (Option) The right to purchase a stock at a specified price over a designated period of time. See *Option*. Compare with *Put option*.

Call Provision (Feature) A provision in a bond contract that allows the borrowing organization to "call" in the bond and pay it off early. Calls are generally exercised when interest rates have dropped substantially since the bond's issue. An additional payment known as the *call premium* must usually be made to the investor if the call is exercised. Most call features cannot be exercised during an initial *call protected* period.

Capital Long-term assets or the money used to support long-term assets and projects. Long-term debt and equity on the balance sheet.

Capital Budgeting Analysis techniques concerned with justifying money spent on long-term assets and projects.

Capital Component One of three sources of capital: debt, preferred stock, or equity.

Capital Gain (Loss) The difference between the sale and purchase prices of an asset held over a period of time.

Capital Gains Yield The capital gain on a stock divided by the price at which it was purchased.

Capital Lease See *Financing lease*.

Capital Market A financial market in which longer-term (at least one year) debt and equity securities are traded.

Capital Rationing In capital budgeting, the process of allocating available capital among projects to maximize total NPV.

Capital Restructuring Changing a firm's capital structure intentionally by buying and selling stocks and bonds simultaneously.

Capital Structure The mix of the three capital components (debt, preferred stock, and equity) used by a firm. The *optimal capital structure* is the structure at which stock price is maximized, all other things held equal. Also see *Target capital structure*.

CAPM Capital asset pricing model. A statistical model of the investment world aimed at explaining how required returns are determined in financial markets and thereby how stock prices are set. Also see *SML*.

Cash Budgeting A forecast of cash flows based on expected receipts and disbursements rather than on projections of income statement and balance sheet accounts.

Cash Flows (Statement of) One of a firm's financial statements. It details the movement of cash in and out of the company. Constructed from the income statement and balance sheet.

Cash Forecast A projection of future cash flows over a specified planning period.

Chapter 11 The chapter of the bankruptcy code dealing with reorganization. Firms in bankruptcy proceedings are commonly said to be "in Chapter 11."

Chartists Technical analysts.

Chief Financial Officer (CFO) The executive in charge of the financial function.

Clean-up Requirement The requirement that borrowers pay off all short-term debt for some period each year. Prevents funding long-term projects with short-term debt.

Clientele Effect The theory that firms attract equity investors at least in part because of their dividend-paying policies. The firm has a "clientele" of stockholders whose need for current or deferred income matches the firm's dividend practices. The implication is that it isn't a good idea to change dividend policies because such a change is bound to displease most stockholders.

Closing Price (Close) The price of a security in the last trade of a business day.

Collateral An asset backing a loan. In the event of default the collateral becomes the property of the lender to satisfy the obligation. Also called *security* for the loan.

Collection Agency A firm that specializes in collecting debts, especially overdue receivables, for a percent of the amount collected.

Commercial Paper Very short-term debt issued by major companies.

Commitment Fee A fee charged by a bank for guaranteeing to have loanable funds available. The fee is charged on unborrowed amounts up to the maximum of the guarantee. See *Revolving credit agreement*.

Common Size Statement A firm's income statement with every line stated as a percent of revenue. A balance sheet with every line stated as a percent of total assets. Used to compare companies of different sizes or to identify performance trends in a single company over time.

Common Stock The security representing ownership of a corporation. Equity.

Compensating Balance A portion of a loan that banks require borrowers to leave in their checking accounts. Effectively increases the bank's yield. A minimum balance required to compensate banks for their services.

Compensation Committee A committee of the board of directors of a corporation charged with reviewing and approving the compensation (pay) of senior executives.

Compound Interest The concept of earning interest on previously earned interest. A sum earning compound interest grows exponentially over time.

Compounding Period The period of time after which interest is credited to the depositor's account for purposes of computing subsequent interest.

Concentration Banking Employing one bank to manage the balances in remote accounts. Balances are generally swept into the concentration bank daily.

Conglomerate Merger A merger between companies in unrelated businesses.

Consolidation A combination of two or more businesses in which all of the old legal entities dissolve and a new one with a new name is formed to continue into the future.

Contribution (Margin) In break-even analysis, contribution is the difference between price and variable cost per unit that is "contributed" toward profit and fixed costs. The contribution margin is the contribution expressed as a percent of price.

Controller The executive in charge of the accounting function in most companies. The controller generally reports to the CFO.

Conversion Price Stating the conversion ratio along with the bond's par value.

Conversion Ratio A ratio set at the time bonds are issued; determines the number of shares that can be exchanged for a bond.

Convertible Bond A bond that can be converted into a specified number of shares of stock at the owner's discretion.

Convertible Currency A currency that can be exchanged for other currencies on foreign exchange markets.

Corporate Governance The practices senior executives and boards of directors use in running corporations. Recently focused on ethics and the financial relationships between executives and the corporations they serve. See *Agency problem*.

Corporate Restructuring A broad term describing a number of ways in which companies are reorganized. Includes capital restructure, mergers, and reorganizations in bankruptcy as well as charges in certain methods of doing business.

Cost Business spending for items closely associated with production. Contrast with expense.

Cost of Capital The average rate a firm pays its investors for the use of their funds, adjusted for taxes and administrative costs. Also called the *WACC* for weighted average cost of capital. Distinguish from the costs of individual capital components that are the adjusted rates paid on debt, preferred stock, and common equity. The component costs are (weighted) averaged to get the WACC.

Cost Structure The mix of fixed and variable cost used by a firm.

Coupon Rate, Coupon Payment The interest rate paid by a bond on its face value. The dollar amount of the interest payment, which is usually made semiannually.

(Restrictive) Covenants Contractual agreements associated with loans that limit the activities of borrowing companies. The limitations are designed to reduce the risk that the firm won't be able to pay the loan's interest and principal.

Credit Agency (Bureau) An organization that maintains records of the bill-paying histories of most companies and assigns *credit ratings* to firms that indicate how well they've paid their bills in the past. The agency's subscribers can receive *credit reports* on companies with which they're considering doing business.

Creditor Anyone owed money by a business, including lenders, vendors, employees, or the government.

Cumulative Feature of Preferred Stock A provision to enhance the safety of preferred stock. If preferred dividends are passed, no common dividends can be paid until preferred dividends are caught up cumulatively.

Cumulative Voting A method of electing boards of directors in which stockholders can cast all of their votes for a single seat. Enables minority interests to get at least some representation on the board.

Current Assets Assets expected to become cash in less than one year. Current assets are largely cash, receivables, and inventories.

Current Liabilities Obligations expected to require cash in less than one year, usually payables and accruals.

Current Ratio Current assets divided by current liabilities. A financial ratio that measures a firm's liquidity, the ability to pay its bills in the short run.

Current Yield A bond's annual interest payment divided by its market price.

D

Date of Record When a dividend is declared, it is paid to owners of record on the transfer agent's books as of the date record.

Debenture An unsecured bond.

Debt Ratio Debt divided by total assets. A financial ratio measuring the degree to which the firm uses borrowed money.

Debt to Equity Ratio The relative amounts of debt and equity in a firm's capital structure.

Decision Tree A timeline representation used in planning projects subject to multiple outcomes. Wherever an event has several outcomes, the timeline branches into as many paths, each with a probability. The result is a proliferation of possible paths to completion, each representing an outcome, its financial implication, and its probability. Hence, the decision tree specifies a probability distribution for the project's overall financial outcome.

Declaration Date The date on which a firm's board of directors declares a dividend.

Deductions Items of expenditure that the tax code allows taxpayers to deduct from income to arrive at taxable income.

Default Risk The risk of loss to a lender from the borrower's failure to pay the full amount due including interest and principal.

Defensive Tactics Actions taken by the management of a company to resist or avoid being acquired.

Depreciation The accounting entry allocating the cost of a long-lived asset against income over the asset's life. Depreciation is a *noncash charge*, so net income is generally less than true cash flow by at least the amount of depreciation.

Derivative Security A security the price of which is derived from the price of another security. The most common example is an option to buy or sell stock. The value of the option is related to the price of the stock being bought or sold. See *Option*.

Diluted EPS Assumes all convertibles are exercised as of the beginning of the year.

Dilution The reduction in earnings and book value per share that results from the conversion of convertible securities or the exercise of warrants or employee stock options at prices below market. Fully diluted values for EPS and book value per share reflect the hypothetical conversion or exercise of all convertibles, warrants, and options outstanding.

Direct Investment In international business, building facilities in another country.

Discount Generally a reduction in price or value. In finance, a reduction in the present value of a future sum due to the action of interest.

Discounted Cash Flow Calculations involving the present and future values of money under the action of compound interest. Also called the *time value of money*.

Diversification In finance, selecting a portfolio of different (diverse) investments to limit the overall risk borne by the investor.

Divestiture Getting rid of a business unit. The reverse of an acquisition.

Dividend The payment made by a corporation to an equity investor (stockholder).

Dividend Decision The decision by management regarding the portion of earnings paid to shareholders as dividends. The alternative is to retain the money, investing it in the company for future growth.

Dividend Theories: Irrelevance, Preference, and Aversion Logical arguments that stockholders should be indifferent to, prefer, or be averse to the payment of dividends.

Dividend Yield A stock's annual dividend divided by its current price.

Double Taxation of Corporate Earnings The primary financial disadvantage of the corporate form. A corporation's earnings are subject to corporate tax when earned and personal tax when paid to stockholders as dividends.

Dunning Pursuing a customer for payment of an overdue receivable.

Du Pont Equations A series of relationships between financial ratios that illustrates the inner workings of businesses and how performance in one area influences performance in others.

E

Earnings Before Interest and Taxes (EBIT) A measure of a firm's performance without regard to how it is financed.

Earnings Dilution A drop in EPS caused by a sale of stock at a below market price.

Economic Order Quantity (EOQ) Model A technique for minimizing the sum of inventory ordering and carrying costs.

Economic Value Added (EVA) A measure of income that recognizes the cost of equity as well as debt. A positive EVA represents a contribution to shareholder wealth over that required by an equity investor, and is viewed as an increment to MVA. EVA is after-tax EBIT less the product of capital and the cost of capital. Also see *MVA*.

Effective Annual Rate (EAR) The annually compounded rate that pays the same interest as a lower rate compounded more frequently.

Efficient Market Hypothesis The assertion that information travels around the U.S. financial system so fast that stock prices virtually always reflect all available information. The concept implies that technical analysis is useless.

EPS Earnings per share. A firm's earnings stated on a per-share outstanding basis. An important measure of business performance in the stock market.

Equity An ownership interest. The portion of a firm's capital representing funds belonging to its shareholders. An equity investment is an investment in stock.

Exercise Price See *Strike price*.

Euro A common European currency adopted in January 2002 by most of the members of the European Union.

Eurobond A bond denominated in a currency other than that of the country in which it is sold.

Eurodollar Market The debt market created when foreign banks with eurodollar deposits lend those funds.

Eurodollars U.S. dollars deposited in banks in other countries.

Exchange A company that provides a physical marketplace and the administrative capability of transferring stocks from one owner to another.

Exchange Rate In international finance, the rate at which one currency can be traded for another. *Spot* rates are available for current trades. *Forward* rates are available for currency to be delivered in a specified period of time.

Exchange Rate Risk The risk that international trade dealings will earn less than expected because of movement in exchange rates.

Ex-Dividend Date The date on which a stock trades without a declared dividend that has yet to be paid. Four days prior to the date of record.

Exemptions (Personal and Dependency) In personal taxes, an amount by which taxable income can be reduced for each person in a household.

Expectations Theory With respect to dividends: a dividend that's lower than expected will be taken as a negative by investors even if it is larger than previous dividends. A variation on the signaling effect of dividends.

With respect to interest rates: A theory explaining the shape of the yield curve. The curve slopes up or down depending on whether expectations about future interest and inflation rates are increasing or decreasing.

Expected Return The return an investor believes is most likely on an investment—that is, the investor understands that the actual return may be somewhat different in certain investments like stocks. The mean of the probability distribution of returns.

Expense An item of expenditure not closely related to production. Contrast with *cost*.

Expropriate In international business, the seizure of assets held in a foreign country by the government of that country.

F

Factoring Receivables Selling receivables to a financing source for an amount less than their face value.

FASB Financial Accounting Standards Board. The body within the accounting profession that sets rules and standards for the form and content of financial statements.

Federal Budget Deficit The amount by which the government's spending exceeds its income in a year. A surplus implies income is greater. See *National debt*.

Finance (noun) The art and science of handling money.

Finance (verb) To raise money to acquire an asset to do some project.

Financial Analyst A person who studies the financial results of businesses and makes recommendations on their values as investments.

Financial Assets Stocks and bonds. More generally a document giving its owner a claim to certain future cash flows. Stocks base that claim on ownership (equity), while bonds base it on debt. Also called a *security*.

Financial Economics A somewhat archaic term for financial theory emphasizing the field's roots in economics.

Financial Instrument A security or financial asset.

Financial Intermediary An institution that pools investors' money and invests it on their behalf giving the investors shares of itself. Mutual funds are the primary example.

Financial Markets Markets in which financial assets are traded—for example, the stock market.

Financial Plan A projection of a company's financial statements into the future based on a series of assumptions about what the business and the environment will do. Part of a business plan.

Financial Ratios See *Ratio analysis*.

Financial Risk The variation in a firm's financial performance caused by using borrowed money (debt, leverage).

Financial Statements Reports created from accounting records that summarize a firm's performance in money terms.

Financing Lease A lease in which the lessee effectively acquires ownership of the leased asset. Also called a *capital lease*. Accounted for by showing the leased asset on the balance sheet offset by a liability representing the obligation to make future lease payments. Compare with *Operating lease*.

Fixed and Total Asset Turnover Sales divided by fixed or total assets. Financial ratios that measure the firm's ability to generate revenue using its assets.

Fixed Financial Charge An expense item that must be paid regardless of how the firm is performing. Essentially, interest and lease payments.

Float Money tied up in the check-clearing process.

Floor Broker A broker who buys and sells on the trading floor of a stock exchange.

Flotation Costs The administrative cost of issuing new securities. Consists largely of commissions and marketing fees, but printing and engraving costs can also be significant.

Forecast A short-term projection of a company's financial results. For example, most firms do regular cash forecasts to predict their immediate funding needs.

Foreign Bond A bond denominated in the currency of the country in which it is sold, but issued by a foreign borrower.

Foreign Exchange A general term for the currency of foreign countries.

Foreign Exchange Market A financial market in which the currencies of different countries are traded.

Free Cash Flow Cash generated by a business above that needed for asset replacement and growth.

Fundamental Analysis A systematic process in which a security is valued by estimating the performance of the underlying company and the future cash flows associated with owning the security. These are discounted to arrive at an *intrinsic value* for the security.

Funds Generally another term for cash.

Future Value The amount a present sum will grow into at a specified interest rate over a specified period of time.

G

GAAP Generally accepted accounting principles. The general rules by which financial records are kept.

Going Concern Value The value of a firm as a profit earning business as opposed to as a collection of assets.

Gordon Model A mathematical model for valuing stock based on an assumed constant growth rate into the indefinite future.

Greenmail To avoid an unfriendly acquisition, a firm may buy shares owned by a potential acquirer at a price above the market price of the stock. The above market payment is greenmail.

Gross Margin Revenue less cost where cost is spending closely associated with production. Stated in dollars or as a percent of revenue. A fundamental measure of a business's strength.

H

Hedging A maneuver or contract that eliminates risk from a transaction. In international trade, eliminating exchange rate risk by purchasing a forward contract for delivery of foreign exchange at a specified rate at a specified time.

Holding Company A company that owns other companies. A *parent* company.

Horizontal Merger A merger between companies in the same line of business, usually as competitors.

I

Indenture Contractual agreements associated with bonds that limit the activities of the issuing companies. The limitations are designed to reduce the risk that the firm won't be able to pay the bond's interest and principal.

Independence Hypothesis In capital structure theory, the original restrictive model by Modigliani and Miller that shows stock price to be independent of capital structure.

In Play A company is in play when it is the object of an acquisition attempt.

Insider Information Information about companies that can influence stock price that is available to insiders but not to the general public. It is illegal to make short-term profits using insider information.

Insolvent A firm is technically insolvent when it can't pay its short-term debts. Legal insolvency implies the firm's liabilities exceed its assets.

Institutional Investor A business organization that buys and sells securities. Generally a fund of some kind such as a mutual fund or a pension fund that invests the pooled money of its clients.

Interest The return on a debt investment.

Interest Rate Risk The risk of loss to an investor from changes in the price of a bond that arise from changes in the market interest rate. Also called *price risk* and *maturity risk*.

International Bond A bond sold outside the home country of the issuing organization (borrower).

Intrinsic Value An underlying or fundamental value. In securities analysis, the price of a security (usually a stock) derived from extensive analysis of the issuing company and its industry. In financial options, the difference between the market price of the underlying stock and the price at which an option on that stock can be exercised (the strike price) if that difference is positive, zero if it is not.

Invest (Investing, Investment) Using a resource (usually money) to improve the future rather than for current consumption. Investment by companies generally means buying assets to be used in their businesses. Investment by individuals usually means buying financial assets (stocks, bonds, savings accounts) that earn a return.

Investment Bank An organization that assists companies in issuing securities and selling them to investors.

Investment Grade Bonds Bonds above a certain quality rating. Moody: Baa; S&P: BBB.

IOS Investment opportunity schedule. A schedule of capital budgeting projects arranged in decreasing order of IRR.

IPO Initial public offering. Stock in a new company offered to the public for the first time. Such stock tends to make a volatile, high-risk investment.

IRR Internal rate of return. A capital budgeting technique that rates projects according to their expected return on invested funds. The higher the return the better.

J

Junk Bonds Risky bonds issued by financially weak companies that pay high rates of interest. Also called *high yield bonds*.

Just in Time (JIT) Just in time inventory systems. In theory, manufacturing parts arrive "just in time" to be used in production, eliminating the need for inventories.

L

LBO Leveraged buyout. A process in which an investor group buys up a company's stock using a small amount of equity and borrowing the rest of the money required. The debt is often secured by the firm's assets. The investor groups are often the firms' managements, and the company goes from being publicly held to being privately held.

Learning on The Trade See *Stretching payables*.

Lease An agreement for the use of an asset in return for payments over a specified period. In recent years, long-term leases have been used to acquire assets rather than purchasing them with debt or equity capital. Lease payments then become fixed financial obligations similar to interest.

(Financial) Leverage The use of borrowed money to multiply financial performance in terms of ROE and EPS.

(Operating) Leverage The use of fixed as opposed to variable cost in a firm's cost structure.

Leveraged Lease A three-party leasing arrangement in which a lender extends credit to a lessor to acquire equipment which is then leased to a user. The loan is usually secured by the leased equipment. Sophisticated tax advantages are associated with the technique.

Limited Liability An advantage of the corporate form. Stockholder liability for the actions of a company is limited to the value of the stock. That is, a suit against the corporation cannot be made against a stockholder simply because the stockholder is an owner.

Line of Credit A relatively informal, nonbinding agreement with a bank as to the maximum amount a firm can borrow during a period of time.

Liquidation Ending a firm's life by selling off its assets.

Liquidity With respect to a company, the ability to pay its bills in the short run. With respect to an asset, the readiness with which it can be converted to cash.

Liquidity Preference Theory A theory of the shape of the yield curve. The curve slopes upward because, all other things equal, investors prefer shorter, more liquid investments. They must therefore be induced to lend longer with higher rates.

Liquidity Risk The risk of loss to an investor from the inability to sell a security to another investor at a price close to its true value.

Listed Company A firm that is traded on an organized exchange is "listed" on that exchange. Unlisted companies are traded, but not on the exchange.

M

Marginal Tax Rate The rate at which the next dollar of income will be taxed. Generally the taxpayer's bracket rate.

Marketable Securities Highly liquid short-term debt investments held by companies instead of cash. Marketable securities provide nearly the liquidity of cash but earn a modest return.

Market Risk Variation on the return on a stock investment caused by things that tend to affect all stocks.

Market Segmentation Theory A theory of the shape of the yield curve. The debt market is segmented by term, and each segment is independent of the others. Hence, the curve slopes up or down depending on supply and demand conditions in the various market segments.

Market Value Added (MVA) The excess of market value measured by the product of stock price and the number of shares outstanding over the book value of equity. An indication of the effectiveness of management in contributing to shareholder wealth. Also see *EVA*.

Marriage Penalty In the tax system, the phenomenon that a two-income married couple pays more tax than the sum of two single people making the same money.

Maturity The date on which the principal of a debt is due. Also the time from the present until that date.

Maturity Matching The idea that the maturity of financing should match the duration of the project being financed.

Maturity Risk The risk of loss to an investor from changes in the price of a bond that arise from changes in the market interest rate. Also called *price risk* and *interest rate risk*. The term *maturity risk* emphasizes the fact that interest-induced price changes are larger with longer maturities.

MCC Schedule Marginal cost of capital schedule. A plot of the WACC (weighted average cost of capital) against the total amount of capital to be raised in a planning period. The MCC rises as more capital is raised and the costs of individual components experience step function increases.

Merger The combination of two or more businesses under one ownership in which all but one legal entity ceases to exist, and the combined organization continues under the name of the surviving firm. When the surviving firm acquires the stock of the other(s), the transaction can be called an acquisition. A merger is *friendly* if it has the approval and support of the acquired *(target)* firm's management. It is *unfriendly* if the target's management resists. The term *merger* tends to be used loosely to refer to any business combination.

Modified Accelerated Cost Recovery System (MACRS) The system of accelerated depreciation allowed for federal tax computations.

Money Market A financial market in which short-term (less than one year) debt securities are traded.

Moral Hazard A condition in which a person can benefit, usually financially, by acting unethically or immorally, i.e., the person is tempted to be less than honest and ethical. An insurance term. A moral hazard exists when executive compensation is heavily based on the market price of the company's stock.

Mortgage Bond A bond secured by real estate.

Mortgage Loan A loan secured by real estate. Commonly referred to simply as a *mortgage*.

Multinational Corporation (MNC) A company with divisions or branches in several countries.

Municipal Bond (Muni) A bond issued by a government unit below the federal level. The interest on municipal bonds is exempt from federal income tax.

Mutual Fund An investment vehicle in which investors contribute to a fund that uses their pooled money to invest in stocks, bonds, and other financial assets. The fund owns the assets, while the investors own shares of the fund.

Mutually Exclusive Projects In capital budgeting, projects that automatically exclude one another. Projects are mutually exclusive either because they're different approaches to doing the same thing or because limited resources preclude doing more than one.

N

NASDAQ (Market) A segment of the stock market that deals in publicly traded stocks that are not listed on an organized exchange. Formerly known as the *OTC market*. NASDAQ is an acronym for the National Association of Securities Dealers Automated Quotation system over which shares are traded.

National Debt The accumulated total of annual federal budget deficits funded by federal government borrowing.

Nominal Interest Rate The named or quoted rate usually stated on an annually compounded basis. May be different from the effective rate due to non-annual compounding.

Noncash Charge An item of cost or expense in the income statement that doesn't require cash. The primary example is depreciation.

Normal Growth In stock pricing models, growth at a rate less than the rate of return. Growth rates in excess of the rate of return are *super normal*.

Note A security reflecting an intermediate- term debt relationship between the issuer and the holder.

NPV Net present value. A capital budgeting technique that rates projects according to the total present value of all their associated cash flows. The higher the total or net present value, the better.

O

Off Balance Sheet Financing Acquiring the use of assets without adding debt to the balance sheet. The primary example is an operating lease. Off balance sheet financing avoids the degradation in financial ratios that generally comes with additional debt. The details of off balance sheet financing must be disclosed in the notes to financial statements.

Operating Lease A lease in which the lessee does not effectively acquire ownership of the leased asset. Accounted for as a stream of expense payments on the income statement. No entry is made on the balance sheet to reflect the acquisition of the asset. The most common form of off balance sheet financing. Compare with *Financing lease*.

Operating Plan A short- to intermediate-term business plan addressing a firm's methods and goals over the period covered. Most companies have an annual operating plan.

Opportunity Cost The benefit foregone by using an asset in a particular way. Usually the income or benefit it would produce in its next best use.

Option (Financial) The contracted right to buy or sell a security at a fixed price within a predetermined period of time, usually three to nine months. Options give speculators the chance to profit on movements in securities' prices without actually owning those securities. For example, the owner of an option to buy will profit if the underlying security's market price rises substantially above the price specified in the option during the option period.

Option (Real) See *Real option*.

Option Price The price an option holder pays for a contract.

OTC Market Over the counter market. A network of securities dealers who trade unlisted (on an exchange) stocks for clients.

P

Payback Period A capital budgeting technique that rates projects according to the speed with which they return invested money.

Payment Date The date on which a dividend check is mailed.

Payout Ratio The percentage of earnings paid to stockholders in dividends.

P/E Ratio The ratio of a firm's stock price to its earnings per share (EPS). A measure of the value the stock market places on the company and its future prospects.

Perpetuity An infinite series of equal payments at equal intervals of time.

Perquisites Privileges and luxuries provided to executives.

Personal Guarantee Generally, a guarantee made by the owner of a small business when a loan is made to the business. The owner pledges his or her personal credit in addition to that of the company. Personal guarantees circumvent the limited liability feature of the corporate form in the context of lending to small businesses.

Planning Assumption An assumption about the future on which a business plan is based. The assumption must be reflected in the firm's financial projections by calculating the specific financial statement figures it implies.

Planning Horizon The time a business plan covers. Typically between a few months and five years.

Pledging Receivables Borrowing money using receivables as collateral.

Poison Pill A corporate tactic to avoid being acquired. A poison pill is a clause written into a firm's bylaws that makes it prohibitively expensive for an acquiring firm to take control.

Political Risk In international business, the chance that the value of a firm's investment in a foreign country will be reduced by political actions of either the foreign government or terrorists.

Portfolio In finance, a collection of investments.

Portfolio Investment In international finance, investment in the securities of a foreign company or government.

Portfolio Theory A body of thought aimed at forming investment portfolios that minimize risk for a given return.

Preemptive Rights A stockholder's right to maintain her proportionate ownership in a corporation. The stockholder has the right to buy a share of any newly issued stock that is proportionate to her fractional ownership of the company before the new issue. The right is not a matter of law but must be written into the corporation's bylaws.

Preferred Stock A security that pays a constant dividend forever. A hybrid between debt and common equity.

Present Value The value today of a sum promised at a specified time in the future given a rate of interest. The amount that would have to be deposited today at the specified interest rate to grow into the promised sum on the specified date.

Price Risk The risk of loss to an investor from changes in the price of a bond that arise from changes in the market interest rate. Also called *interest rate risk* and *maturity risk*.

Primary Market A subdivision of financial markets in which securities are sold for the first time. The sale is by the issuing company to investors. Compare with *Secondary market*.

Prime Rate The interest rate banks charge their largest and best commercial customers.

Privately Held Company A company that is not registered with the SEC and whose securities therefore may not be sold to the general public. Also called a *closely held company*.

Profitability Index (PI) A capital budgeting technique that rates projects according to the ratio of the present value of cash inflows to the present value of cash outflows. Essentially a variation on the NPV technique. The higher the PI the better.

Progressive Tax An income tax structure in which higher incomes are taxed at higher rates.

Promissory Note A lending agreement in which the borrower promises to pay principal and interest in accordance with specific terms.

Prospectus A document disclosing the details of a security and the underlying business to prospective investors.

Proxy The right to act for another on a specific issue. In finance the right to cast another's vote in the election of corporate directors. Incumbent directors routinely solicit stockholders' proxies for reelection.

Proxy Fight A fight for control of a corporation when two or more interests compete for the proxies of shareholders in the election of directors.

Public Company Accounting Oversight Board (PCAOB) An independent board created by the Sarbanes-Oxley Act to oversee the activities of the public accounting (auditing) industry. Operates under the direction of the SEC.

Publicly Traded Company A company that is registered with the SEC and whose securities therefore may be sold to the general public.

Pure Interest Rate The earning power of money. An interest rate without an inflation component or premiums for risk.

Pure Play Company A firm in a single line of business, as opposed to a firm with divisions in several businesses.

Put (Option) The right to sell a stock to another at a specified price over a designated period of time. See *Option*. Compare with *Call option*.

Q

Quick Ratio Current assets less inventories divided by current liabilities. A financial ratio that measures a firm's liquidity, the ability to pay its bills in the short run, without depending on converting inventory into cash. Also called the *Acid Test*.

R

Ratio Analysis A technique of analyzing the strength of a company by forming (financial) ratios out of sets of numbers from the financial statements. Ratios are compared with the competition, recent history, and the firm's plan to assess the quality of its performance.

Real Asset A tangible object with value derived from the service it provides such as a house or a car. Distinguish from a financial asset, which is a piece of paper giving its owner a claim to future cash flows.

Real Option The ability to take a course of action that under certain circumstances leads to a benefit. The circumstances that make the action desirable are uncertain, and maintaining the ability to take it requires expenditures before that uncertainty is resolved. Hence, bearing the preliminary cost gives one the option of taking an action in the future that may or may not turn out to be desirable.

Recourse In secured lending, if the asset collateralizing a loan proves not to have the value anticipated, recourse implies the borrower is still responsible for the debt. The lender is said to have recourse to the borrower.

Red Herring A prospectus for the sale of a security not yet approved by the SEC. Stamped with the word *preliminary* in red letters.

Registered Securities Securities with which the issuer or a *transfer agent* keeps a list of the names of owners. Dividends or interest payments are made to *owners of record* as of specified dates.

Regulation Analyst Certification (Reg AC) A regulation promulgated by the SEC as a result of the Sarbanes-Oxley Act which requires securities analysts to certify that they actually believe in what they say in their reports and that their pay is not tied to their recommendation.

Reorganization In bankruptcy, a plan to restructure the failing company so that it may continue in business.

Required Return The minimum return that keeps an investor in a particular stock. Generally a function of the risk perceived in the investment.

Residual Claim Stockholders' claim to income and assets is the residual after all other claims are satisfied.

Residual Dividend Theory The idea that corporations pay dividends with whatever money is left over out of earnings after all projects with a positive NPV are undertaken.

Residual Value The value of a leased asset at the termination of the lease.

(Debt) Restructuring A change in a bankrupt firm's debt obligations aimed at allowing it to continue in business. In an *extension* creditors agree to give the firm longer to pay. In a *composition* creditors agree to settle for less than the full amount owed.

Return The payment to an investor for the use of funds. Usually expressed as a percent of the investment.

Revolving Credit Agreement A formal, binding agreement with a bank as to the maximum amount a firm can borrow during a period of time. Interest is paid on the amount borrowed and a commitment fee is paid on the unused balance.

Risk (in Finance) The probability that the return on an investment will be less than expected. The variability of the return on a particular investment. The variance of the probability distribution of return.

Risk-Adjusted Rates In capital budgeting, a rate used in place of the cost of capital to reflect especially risky projects.

Risk Aversion The premise that most people prefer lower risk investments when expected returns are about equal.

Risk-Free Rate The interest rate excluding all risk premiums. The risk-free rate consists of the pure rate and an inflation adjustment. It is approximated by the three-month treasury bill rate. Written as k_{RF}.

Risk Premium A component of a rate of interest or return that compensates the investor for bearing some kind of risk.

ROA Return on assets. Net income divided by total assets. A financial ratio measuring performance concentrating on profitability and asset utilization.

ROE Return on equity. Net income divided by equity. A financial ratio measuring performance concentrating on profitability, asset utilization, and the use of borrowed money.

ROS Return on sales. Net income divided by sales revenue. A financial ratio measuring performance concentrating on profitability.

S

Safety Stock Extra inventory carried to prevent stockouts in the event of heavy use or delayed delivery.

Scenario Analysis A business planning technique in which the implications of variations in planning assumptions are explored. Also known as "what-if-ing."

Seasoned Issue An older bond.

Secondary Market Sales of existing securities between investors. Compare with *Primary market*.

Secured Debt Debt backed by specific assets (the security or collateral) that become the property of the lender in the event of default.

Securities Analysis A systematic approach to valuing securities, especially stocks, by studying an issuing firm's business and industry. The *securities analyst* plays an important role in the financial industry.

Securities and Exchange Commission (SEC) The federal agency responsible for regulating securities dealings.

Security A financial asset. Commonly a stock or a bond. An asset pledged to guarantee the repayment of a loan.

Signaling Effect of Dividends The idea that dividends send a message about management's confidence in the future of the firm—that is, paying a regular or increased dividend signals that the firm is fundamentally sound even if it appears to be having problems. The signaling idea leads to the practice of holding dividends constant or raising them in the face of poor financial performance. Also known as the *information* effect of dividends.

Sinking Fund An arrangement to guarantee that funds are available to pay off a bond's principal at maturity.

SML Security market line. The central element of the CAPM. The SML purports to explain how the market sets the required return on a stock investment.

Specialist An official in a stock exchange. The specialist is assigned the stocks of specific companies and is responsible for conducting an orderly market in those securities.

Speculation The assumption of measured risks in the hope of financial gain, usually with substantial knowledge of the processes that generate gains and losses.

Spinoff A method of divesting a business unit by setting it up as a separate company and giving its shares to stockholders in proportion to their holdings of the original firm. After the spinoff stockholders can trade the two stocks separately.

Spontaneous Financing Financing provided by current liabilities that arise automatically as a result of doing business.

Stable Dividend A dividend that may remain constant or increase over time but that does not decrease.

Stand-Alone Project In capital budgeting, a project with no competition either for the task it is to accomplish or for resources.

Stand-Alone Risk The risk associated with investing in a stock that's held by itself, outside of a portfolio. Stand-alone risk depends on the volatility of a stock's own return rather than on the effect its inclusion has on the volatility of the return of a portfolio.

Stock A financial asset representing a share of ownership of a corporation. Entitles the owner to dividends if any are paid.

Stockbroker A person licensed to assist investors in buying and selling securities for a commission.

Stock Dividend Essentially a stock split in which the number of new shares issued is less than or equal to 20% of the original number outstanding.

Stock Exchange A physical place in which stocks are traded by brokers on behalf of their investor clients.

Stock Market The network of exchanges, brokers, and investors that trade in stocks.

(Employee) Stock Option A right given to a corporate employee to purchase a designated number of shares of the company's stock at a fixed price over a specified period. If the company's stock price rises above the fixed, optioned price during the period, the employee can make a profit by buying below market and selling at market. Stock options can be given to employees at any level, but large blocks are generally awarded to senior executives as performance incentives. Executive stock options are controversial because they contribute to a short-run focus on stock price on the part of management, and may create an incentive to artificially and/or fraudulently pump up stock price.

Stockout An inventory shortage.

Stock Split A change in the number of shares outstanding by issuing new shares in proportion to those already owned. All stockholders' proportionate ownership is maintained, and no economic value is created. Used to keep stock prices within a desirable trading range.

Strategic Plan A long-term business plan addressing broad issues of what a company's management wants it to become and how it is to do business.

Stretching Payables Paying invoices after they're due according to the terms of sale. Also called *leaning on the trade*.

Strike Price The price at which an optioned stock can be bought or sold. Also called the *exercise price* or *striking price*. See *Option*.

S-Type Corporation A corporate form in the tax code that gives small businesses some of the benefits of both the traditional corporation and the proprietorship. Most notably, S-type corporations escape the double taxation of earnings.

Subordinated Debt Debt with a lower priority for the payment of interest and principal than other (senior) debt.

Sunk Cost A cost associated with a project expended prior to making the decision to undertake that project (for example, the cost of research into the idea). Since sunk funds are already gone, they cannot alter future costs or benefits, and should not be included in the analysis leading to a decision.

Sustainable Growth Rate The rate at which a firm can grow if none of its financial ratios change and it doesn't raise any new equity by selling stock. The growth in equity created by earnings retained.

Synergy A situation in which two companies operating together under one ownership perform better than the sum of their separate performances. A popular reason claimed for mergers.

T

Takeover The transfer of control over a company from one group to another. The term generally has a hostile implication.

Target Capital Structure The capital structure that management strives to maintain as new capital is raised. An estimate of the structure that maximizes stock price.

Target Company The object of a corporate acquisition or merger. See *Merger*.

Tax Base The thing that is taxed. Generally income, wealth, or consumption.

Tax Bracket A range of income over which the tax rate is constant.

Tax Loss Carry Back (or Forward) The allocation of losses in a year to previous or subsequent years for the purpose of calculating taxes in those years. Losses may be carried back three and forward 15 years.

Technical Analysis An approach to valuing securities by examining past patterns of price and volume. The technique is based on the idea that such patterns repeat themselves.

Temporary Working Capital Working capital that supports seasonal peaks in business.

Tender Offer A general offer to stockholders to purchase shares at a specified price, usually for the purpose of acquiring a company.

10-K Report A supplement to the annual report that public companies must file with the SEC.

Term The time until a debt security's principal is due to be repaid. Also called the *debt's maturity* or *time until maturity*.

Terms of Sale The conditions under which a sale is made primarily with respect to payment. Terms include a date on which payment is due and often specify a *prompt payment discount* that may be taken if payment is made within a specified time.

Time Premium The difference between intrinsic value and the option price.

Time Value of Money Calculations involving the present and future values of money under the action of compound interest. Also called *discounted cash flow*.

Top-Down Planning Business planning based on a set of goals forced on the organization by senior management. Top-down planning has a tendency to lead to excessively optimistic plans.

Total Effective Tax Rate (TETR) The combined income tax rate including federal and state tax. Less than the sum of the two because state tax is deductible from federal tax.

Trade Credit Credit granted in the normal course of business between companies. That is, vendors don't usually demand immediate payment for their products.

Trading Range A price range in which stocks are thought to appeal to the widest variety of investors. Typically between $30 and $100. Stock splits function to keep prices within a trading range when the stock is appreciating.

Transaction Gain or Loss The difference between the net result of an international transaction and what was initially expected that arises from variation in exchange rates.

Transfer Agent An organization that keeps records of the owners of a company's securities. When a security is sold by one investor or to another, ownership is transferred on the record by the transfer agent.

Translation Risk The gain or loss on the value of assets and liabilities held in another country that results from variation in exchange rates. Generally relatively meaningless as long as the foreign operation is not liquidated or sold. Therefore not generally taxable.

Treasurer The executive in charge of external financing in most companies. The treasurer generally reports to the CFO.

Trustee With respect to bonds, an organization that ensures compliance with the conditions set forth in the indenture. With respect to bankruptcy, a person who administers the bankrupt organization to ensure funds are properly handled.

V

Valuation A systematic process to determine the price at which a security should sell in financial markets.

Vertical Merger A merger between companies when one is a supplier or a customer of the other.

W

WACC See *Cost of capital*.

Warehousing In finance, a method of securing the lender's interest when borrowing is secured by inventories. The inventory is placed in a warehouse operated by a third party. When it is drawn out of the warehouse by the borrower, a pro rata share of payment on the loan is due.

Warrant A security that grants its owner the right to purchase one or more shares of stock at a designated price over a limited period. Similar to a call option except that a warrant is issued by the company that issued the underlying stock while a call is issued by another investor. Also different in that warrants tend to be exercisable over much longer periods than calls.

What-if-Ing See *Scenario analysis*.

White Knight When a firm is an acquisition target by an unattractive suitor, a more desirable acquirer is known as a white knight. (The original suitor may be known for particularly ruthless treatment of acquired companies.)

Widely Held Company A corporation whose ownership is distributed over a large number of people with no single individual or group having a significant proportion.

Working Capital The balance sheet accounts associated with day-to-day operating activities. *Gross working capital* is generally defined as current assets and *net working capital* as current assets minus current liabilities.

Y

Yield Return.

Yield Curve The relationship between interest rates and the term of debt, generally expressed graphically. A *normal* yield curve is upsloping, reflecting rates that increase with increasing term. An *inverted* curve is downsloping.

YTC Yield to call. Bond pricing calculations assuming the bond will be called at the end of the protected period.

YTM Yield to maturity. Bond pricing calculations assuming the bond will pay interest until maturity at which time it will repay its principal (face value).

Z

Zero Coupon Bond A bond that pays no interest during its life. A "zero" sells for the present value of the principal repayment. However, the IRS imputes interest during the bond's life on which the bondholder must pay tax.