

# Glossary

**accounting book value**—the value of an asset as shown on a firm's balance sheet. It represents the depreciated historical cost of the asset rather than its current market value or replacement cost.

**accounts payable (trade credit)**—credit provided by suppliers when a firm purchases inventory on credit.

**accounts receivable**—money owed by customers who purchased goods or services from the firm on credit.

**accounts receivable turnover ratio**—a firm's credit sales divided by its accounts receivable. This ratio expresses how often accounts receivable are "rolled over" during a year.

**accrual basis accounting**—a method of accounting whereby revenue is recorded when it is earned, whether or not the revenue has been received in cash. Likewise, expenses are recorded when they are incurred, even if the money has not actually been paid out.

**accrued expenses**—expenses that have been incurred but not yet paid in cash.

**accumulated depreciation**—the sum of all depreciation taken over the entire life of a depreciable asset.

**acid-test (quick) ratio**—the sum of firm's cash and accounts receivable divided by its current liabilities. This ratio is a more stringent measure of liquidity than the current ratio because it excludes inventories and other current assets (those that are least liquid) from the numerator.

**agency costs**—the lost value a firm's security holders face where there are conflicts of interest between managers and the security holders.

**agency problem**—problems and conflicts resulting from the separation of the management and ownership of the firm.

**amortized loan**—a loan that is paid off in equal periodic payments.

**angel investor**—a wealthy private investor who provides capital for a business start-up.

**annuity**—a series of equal dollar payments made for a specified number of years.

**annuity due**—an annuity in which the payments occur at the beginning of each period.

**annuity future value factor**—the value of  $\left[ \frac{(1 + r)^n - 1}{r} \right]$  used as a multiplier to calculate the future value of an annuity.

**annuity present value factor**—the value of  $\left[ \frac{1 - (1 + r)^{-n}}{r} \right]$  used as a multiplier to calculate the present value of an annuity.

**anticipatory buying**—buying in anticipation of a price increase to secure goods at a lower cost.

**arbitrage**—trading to eliminate exchange rate differentials across the markets for a single currency.

**arbitrageur**—an individual involved in the process of buying and selling in more than one market to make a riskless profit.

**asked rate**—the rate the bank or the foreign exchange trader "asks" the customer to pay when the bank is selling and the customer is buying. The asked rate is also known as the selling rate or the offer rate.

**asset allocation**—identifying and selecting the asset classes appropriate for a specific investment portfolio and determining the proportions of those assets within the portfolio.

**asset management**—how efficiently management is using the firm's assets to generate sales.

**average tax rate**—the tax rate on average that a company pays on its total taxable income.

**balance sheet**—a statement that shows a firm's assets, liabilities, and shareholder equity at a given point in time. It is a snapshot of the firm's financial position on a particular date.

**balance-sheet leverage ratios**—ratios of a firm's use of financial leverage or debt capital to either the firm's total capital or equity. Since the needed information for computing these ratios is found in the balance sheet we refer to them as balance sheet leverage ratios.

**behavioral finance**—the field of study examining when investors act rationally or irrationally when making investment decisions.

**beta**—the relationship between an investment's returns and the market's returns. This is a measure of the investment's nondiversifiable risk.

**bid-asked spread**—the difference between the asked quote and the bid quote.

**bid rate**—the rate at which the bank buys the foreign currency from the customer. The bid rate is also known as the buying rate.

**bird-in-the-hand dividend theory**—the view that dividends are more certain than capital gains and therefore more valuable.

**bond**—a long-term (10-year or more) promissory note issued by the borrower, promising to pay the owner of the security a predetermined, fixed amount of interest each year.

**book value**—(1) the value of an asset as shown on the firm's balance sheet. It represents the historical cost of the asset rather than its current market value or replacement cost. (2) The depreciated value of a company's assets (original cost less accumulated depreciation) less outstanding liabilities.

**break-even quantity**—the number of units a firm must sell before it starts to earn a profit.

**budget**—an itemized forecast of a company's expected revenues and expenses for a future period.

**business risk**—the risk of the firm's future earnings that is a direct result of the particular line of business chosen by the firm.

**call protection period**—a prespecified time period during which a company cannot recall a bond.

**call provision**—a provision that entitles the corporation to repurchase its preferred stock from investors at stated prices over specified periods.

**callable bond (redeemable bond)**—an option available to a company issuing a bond whereby the issuer can call (redeem) the bond before it matures. This is usually done if interest rates decline below what the firm is paying on the bond.

**capital asset pricing model (CAPM)**—an equation stating that the expected rate of return on an investment (in this case a stock) is a function of (1) the risk-free rate, (2) the investment's systematic risk, and (3) the expected risk premium for the market portfolio of all risky securities.

**capital budgeting**—the decision-making process with respect to investment in fixed assets.

**capital gains**—gains from selling any asset that is not part of the ordinary operations.

**capital markets**—all institutions and procedures that facilitate transactions in long-term financial instruments.

**capital rationing**—placing a limit on the dollar size of the capital budget.

**capital structure**—the mix of long-term sources of funds used by the firm. This is also called the firm's capitalization. The relative total (percentage) of each type of fund is emphasized.

**capital structure decision**—the decision-making process with funding choices and the mix of long-term sources of funds.

**cash**—cash on hand, demand deposits, and short-term marketable securities that can quickly be converted into cash.

**cash basis accounting**—a method of accounting whereby revenue is recorded when physical cash is actually received. Likewise, expenses are recorded when physical cash is paid out.

**cash budget**—a detailed plan of future cash flows. This budget is composed of four elements: cash receipts, cash disbursements, net change in cash for the period, and new financing needed.

**characteristic line**—the line of “best fit” through a series of returns for a firm's stock relative to the market's returns. The slope of the line, frequently called beta, represents the average movement of the firm's stock returns in response to a movement in the market's returns.

**chattel mortgage agreement**—a loan agreement in which the lender can increase his or her security interest by having specific items of inventory identified in the loan agreement. The borrower retains title to the inventory but cannot sell the items without the lender's consent.

**cliente effect**—the belief that individuals and institutions will invest in companies whose dividend payouts match their particular needs for current versus future cash flow. For example, those that need current income will invest in companies that have high dividend payouts.

**combined, or total, leverage**—the result of the combined effects of both operating and financial leverage.

**commercial paper**—short-term unsecured promissory notes sold by large businesses in order to raise cash. Unlike most other money-market instruments, commercial paper has no developed secondary market.

**common-sized balance sheet**—a balance sheet in which a firm's assets and sources of debt and equity are expressed as a percentage of its total assets.

**common-sized income statement**—an income statement in which a firm's expenses and profits are expressed as a percentage of its sales.

**common stock**—shares that represent ownership in a corporation.

**common stockholders**—investors who own the firm's common stock. Common stockholders are the residual owners of the firm.

**company-unique risk**—see unsystematic risk.

**compensating balance**—a balance of a given amount that the firm maintains in its demand deposit account. It may be required by either a formal or an informal agreement with the firm's commercial bank. Such balances are usually required by the bank (1) on the unused portion of a loan commitment, (2) on the unpaid portion of an outstanding loan, or (3) in exchange for certain services provided by the bank, such as check-clearing or credit information. These balances raise the effective rate of interest paid on borrowed funds.

**compound annuity**—depositing an equal sum of money at the end of each year for a certain number of years and allowing it to grow.

**compound interest**—the situation in which interest paid on an investment during the first period is added to the principal. During the second period, interest is earned on the original principal plus the interest earned during the first period.

**constant dividend payout ratio**—a dividend payment policy in which the percentage of earnings paid out in dividends is held constant. The dollar amount fluctuates from year to year as profits vary.

**contribution-to-firm risk**—the amount of risk that the project contributes to the firm as a whole; this measure considers the fact that some of the project's risk will be diversified away as the project is combined with the firm's other projects and assets but ignores the effects of diversification of the firm's shareholders.

**convertible bond**—a debt security that can be converted into a firm's stock at a pre-specified price.

**convertible preferred stock**—preferred shares that can be converted into a pre-determined number of shares of common stock, if investors so choose.

**corporation**—an entity that legally functions separate and apart from its owners.

**cost of common equity**—the rate of return that must be earned on the common stockholders' investment in order to satisfy their required rate of return.

**cost of debt**—the rate that has to be received from an investment in order to achieve the required rate of return for the creditors.

**cost of goods sold**—the cost of producing or acquiring a product or service to be sold in the ordinary course of business.

**cost of preferred equity**—the rate of return that must be earned on the preferred stock-

holders' investment in order to satisfy their required rate of return.

**coupon interest rate**—the interest rate contractually owed on a bond as a percent of its par value.

**coverage ratios**—ratios of the firm's earnings to the interest and principal related to a firm's borrowing.

**credit scoring**—the numerical evaluation of credit applicants where the score is evaluated relative to a predetermined standard.

**cross rate**—the exchange rate between two foreign currencies, neither of which is the currency of the domestic country.

**cumulative feature**—a requirement that all past, unpaid preferred stock dividends be paid before any common stock dividends are declared.

**cumulative voting**—voting in which each share of stock allows the shareholder a number of votes equal to the number of directors being elected. The shareholder can then cast all of his or her votes for a single candidate or split them among the various candidates.

**current assets (gross working capital)**—current assets consist primarily of cash, marketable securities, accounts receivable, inventories, and other current assets.

**current debt (short-term liabilities)**—debt due to be paid within 12 months.

**current ratio**—the firm's current assets divided by its current liabilities. This ratio indicates a company's degree of liquidity by comparing its current assets to its current liabilities.

**current yield**—the ratio of a bond's annual interest payment to its market price.

**date of record**—the date at which the stock transfer books are to be closed for determining the investors to receive the next dividend payment.

**days in inventory**—inventory divided by daily cost of goods sold. This ratio measures the number of days a firm's inventories are held on average before being sold; it also indicates the quality of the inventory.

**days in receivables (average collection period)**—a firm's accounts receivable divided by the company's average daily credit sales (annual credit sales ÷ 365). This ratio expresses how many days on average it takes to collect receivables.

**debenture**—any unsecured long-term debt.

**debt**—liabilities consisting of such sources as credit extended by suppliers or a loan from a bank.

**debt capacity**—the maximum amount of debt that the firm can include in its capital

structure and still maintain its current credit rating.

**debt-equity composition**—the mix of debt and equity used by the firm in its capital structure.

**debt maturity composition**—the mix of short- and long-term debt used by the firm.

**debt ratio**—a firm's total liabilities divided by its total assets. This ratio measures the extent to which a firm has been financed with debt.

**declaration date**—the date upon which a dividend is formally declared by the board of directors.

**default-risk premium**—the additional return required by investors to compensate them for the risk of default. It is calculated as the difference in rates between a U.S. Treasury bond and a corporate bond of the same maturity and marketability.

**delivery date**—the date on which the actual payment of one currency in exchange for another takes place in a foreign exchange transaction.

**delivery-time stock**—the inventory needed between the order date and the receipt of the inventory ordered.

**depreciation expense**—a noncash expense to allocate the cost of depreciable assets, such as plant and equipment, over the life of the asset.

**direct costs**—see **variable costs**.

**direct foreign investment (DFI)**—a company from one country making a physical investment, such as building a factory, in another country.

**direct quote**—the exchange rate that indicates the number of units of the home currency required to buy one unit of a foreign currency.

**direct sale**—the sale of securities by a corporation to the investing public without the services of an investment-banking firm.

**discount bond**—a bond that sells at a discount, or below par value.

**discounted payback period**—the number of years it takes to recapture a project's initial outlay from the discounted free cash flows.

**discretionary financing**—sources of financing that require an explicit decision on the part of the firm's management every time funds are raised. Bank notes provide a typical example of this type of financing.

**diversifiable risk**—see **unsystematic risk**.

**dividend-payout ratio**—dividends as a percentage of earnings.

**dividends per share**—the amount of dividends a firm pays for each share outstanding.

**divisional WACC**—the cost of capital for a specific business unit or division.

**Dutch auction**—a method of issuing securities (common stock) by which investors place bids indicating how many shares they are willing to buy and at what price. The price the stock is then sold for becomes the lowest price at which the issuing company can sell all the available shares.

**earnings before taxes (taxable income)**—operating income minus interest expense.

**earnings per share**—net income on a per share basis.

**EBIT-EPS indifference point**—the level of earnings before interest and taxes (EBIT) that will equate earnings per share (EPS) between two different financing plans.

**economic value added**—measures a company's economic profits, as compared to its accounting profits, by including not only interest expense as a cost but also the shareholders' required rate of return on their investment.

**effective annual rate (EAR)**—the annual compound rate that produces the same return as the nominal, or quoted, rate when something is compounded on a nonannual basis. In effect, the EAR provides the true rate of return.

**efficient market**—market where the values of all securities fully recognize all available public information.

**equity**—stockholders' investment in the firm and the cumulative profits retained in the business up to the date of the balance sheet.

**equivalent annual annuity (EAA)**—an annuity cash flow that yields the same present value as the project's *NPV*.

**Eurobond**—a bond issued in a country different from the one in which the currency of the bond is denominated; for example, a bond issued in Europe or Asia by an American company that pays interest and principal to the lender in U.S. dollars.

**Eurodollars**—U.S. dollars held by foreign (often European) banks and financial institutions outside the United States, and often as a result of payments to foreign companies for good or services.

**exchange rate**—the price of one currency stated in terms of another.

**ex-dividend date**—the date upon which stock brokerage companies have uniformly decided to terminate the right of ownership to the dividend, which is two days prior to the date of record.

**expectations theory**—the notion that investor reactions to a managerial decision are based on their *assessment* of the effect of the action on stock price. For example, the announcement of a higher dividend not only indicates that more cash will be received by investors this quarter but may also signal

to investors that the firm's future prospects have improved.

**expected rate of return**—The rate of return investors expect to receive on an investment by paying the current market price of the security.

**external financing needs**—that portion of a firm's requirements for financing that exceeds its sources of internal financing (i.e., the retention of earnings) plus spontaneous sources of financing (e.g., trade credit).

**factor**—a firm that, in acquiring the receivables of other firms, bears the risk of collection and, for a fee, services the accounts.

**factoring accounts receivable**—the outright sale of a firm's accounts receivable to another party (the factor) without recourse. The factor, in turn, bears the risk of collection.

**fair value**—the present value of an asset's expected future cash flows.

**field-warehouse agreement**—a security agreement in which inventories pledged as collateral are physically separated from the firm's other inventories and placed under the control of a third-party field-warehousing firm.

**financial leverage**—results from the firm's use of sources of financing that require a fixed rate of return. The primary example of such a form of financing is fixed interest rate debt whereby the firm must pay predetermined interest and principal on specified dates.

**financial markets**—those institutions and procedures that facilitate transactions in all types of financial claims.

**financial policy**—the firm's policies regarding the sources of financing it plans to use and the particular mix (proportions) in which they will be used.

**financial ratios**—accounting data restated in relative terms in order to help people identify some of the financial strengths and weaknesses of a company.

**financial risk**—risk driven by the presence of fixed finance costs in the firm's capital structure (as opposed to variable finance costs such as dividends declared and paid).

**financial structure**—the mix of all sources of fundings that appears on the right-hand side of the balance sheet.

**financing cash flows**—the amount of cash received from or distributed to the firm's investors, usually in the form of interest, dividends, issuance of debt, or issuance or repurchase of stocks.

**finished-goods inventory**—goods on which the production has been completed but that are not yet sold.

**fixed asset turnover**—a firm's sales divided by its net fixed assets. This ratio indicates

how efficiently the firm is using its fixed assets.

**fixed assets**—assets such as equipment, buildings, and land.

**fixed costs**—costs that do not vary in total dollar amount as sales volume or quantity of output changes. Also called **indirect costs**.

**fixed-rate bond**—a bond that pays a fixed amount of interest to the investor each year.

**float**—the length of time from when a check is written until the actual recipient can draw upon the funds.

**floating lien agreement**—an agreement, generally associated with a loan, whereby the borrower gives the lender a lien against all its inventory.

**flotation costs**—the costs incurred by the firm when it issues securities to raise funds.

**foreign exchange (FX) market**—the market in which the currencies of various countries are traded.

**Form 10-K**—an annual report required by the Securities and Exchange Commission (SEC) that provides such information as the firm's history, audited financial statements, management's analysis of the company's performance, and executive compensation.

**forward exchange contract**—an agreement between two parties to exchange one currency for another on a future date.

**forward exchange rate**—an exchange rate for a transaction that calls for delivery in the future.

**forward-spot differential**—the premium or discount between forward and spot currency exchange rates.

**free cash flows**—the amount of cash available from operations after the firm pays for the investments it has made in operating working capital and fixed assets. This cash is available to distribute to the firm's creditors and owners.

**future value**—the amount to which your investment will grow, or a future dollar amount.

**future value factor**—the value of  $(1 + r)^n$  used as a multiple to calculate an amount's future value.

**futures markets**—markets where you can buy or sell something at a future date.

**general partnership**—a partnership in which all partners are fully liable for the indebtedness incurred by the partnership.

**Generally Accepted Accounting Principles (GAAP)**—rule-based set of accounting principles, standards, and procedures that companies use to compile their financial

statements. These principles are issued by the Financial Accounting Standards Board.

**gross fixed assets**—the original cost of a firm's fixed assets.

**gross profit**—sales or revenue minus the cost of goods sold.

**gross profit margin**—gross profit divided by net sales. It is a ratio denoting the gross profit earned by the firm as a percentage of its net sales.

**hedging principle (principle of self-liquidating debt)**—a working-capital management policy which states that the cash-flow-generating characteristics of a firm's investments should be matched with the cash-flow requirements of the firm's sources of financing. Very simply, short-lived assets should be financed with short-term sources of financing while long-lived assets should be financed with long-term sources of financing.

**high-yield bond**—see junk bond.

**holding-period return (historical or realized rate of return)**—the rate of return earned on an investment, which equals the dollar gain divided by the amount invested.

**income statement (profit and loss statement)**—a basic accounting statement that measures the results of a firm's operations over a specified period, commonly 1 year. The bottom line of the income statement, net profits (net income), shows the profit or loss for the period that is available for a company's owners (shareholders).

**incremental cash flow**—the difference between the cash flows a company will produce both with and without the investment it is thinking about making.

**indenture**—the legal agreement between the firm issuing bonds and the bond trustee who represents the bondholders, providing the specific terms of the loan agreement.

**indirect costs**—see **fixed costs**.

**indirect quote**—the exchange rate that expresses the number of units of foreign currency that can be bought for one unit of home currency.

**inflation premium**—a premium to compensate for anticipated inflation that is equal to the price change expected to occur over the life of the bond or investment instrument.

**information asymmetry**—the notion that investors do not know as much about the firm's operations as the firm's management.

**initial outlay**—the immediate cash outflow necessary to purchase the asset and put it in operating order.

**initial public offering, IPO**—the first time a company issues its stock to the public.

**insolvency**—the inability to meet interest payments or to repay debt at maturity.

**intercept**—the constant term in a linear equation. This is the value predicted in a linear equation for the item being forecast (e.g., operating expenses) where revenues are equal to zero.

**interest rate parity (IRP) theory**—a theory that states that (except for the effects of small transaction costs) the forward premium or discount should be equal and opposite in size to the difference in the national interest rates for securities of the same maturity.

**interest rate risk**—the variability in a bond's value caused by changing interest rates.

**internal growth**—a firm's growth rate resulting from reinvesting the company's profits rather than distributing them as dividends. The growth rate is a function of the amount retained and the return earned on the retained funds.

**internal rate of return (IRR)**—the rate of return that the project earns. For computational purposes, the internal rate of return is defined as the discount rate that equates the present value of the project's free cash flows with the project's initial cash outlay.

**International Financial Reporting Standards (IFRS)**—a principle-based set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements. The principles are issued by the International Accounting Standards Board.

**intrinsic, or economic, value**—the present value of an asset's expected future cash flows. This value is the amount the investor considers to be fair value, given the amount, timing, and riskiness of future cash flows.

**inventories**—raw materials, work in progress, and finished goods held by the firm for eventual sale.

**inventory loans**—loans secured by inventories. Examples include floating or blanket lien agreements, chattel mortgage agreements, field-warehouse receipt loans, and terminal-warehouse receipt loans.

**inventory management**—the control of assets used in the production process or produced to be sold in the normal course of the firm's operations.

**inventory turnover**—a firm's cost of goods sold divided by its inventory. This ratio measures the number of times a firm's inventories are sold and replaced during the year, that is, the relative liquidity of the inventories.

**investment banker**—a financial specialist who underwrites and distributes new

securities and advises corporate clients about raising new funds.

**junk bond**—any bond rated BB or below.

**just-in-time inventory control system**—a production and management system in which inventory is cut down to a minimum through adjustments to the time and physical distance between the various production operations. Under this system the firm keeps a minimum level of inventory on hand, relying upon suppliers to furnish parts “just in time” for them to be assembled.

**law of one price**—an economic principle that states that a good or service cannot sell for different prices in the same market. Applied to international markets, this law states that the same goods should sell for the same price in different countries after making adjustment for the exchange rate between the two currencies.

**limited liability**—a protective provision whereby the investor is not liable for more than the amount he or she has invested in the firm.

**limited liability company (LLC)**—a cross between a partnership and a corporation under which the owners retain limited liability but the company is run and is taxed like a partnership.

**limited partnership**—a partnership in which one or more of the partners has limited liability, restricted to the amount of capital he or she invests in the partnership.

**line of credit**—generally an informal agreement or understanding between a borrower and a bank as to the maximum amount of credit the bank will provide the borrower at any one time. Under this type of agreement there is no “legal” commitment on the part of the bank to provide the stated credit.

**liquidation value**—the dollar sum that could be realized if an asset were sold.

**liquidity**—the ability to convert an asset into cash quickly without a significant loss of its value.

**liquidity preference theory**—the theory that the shape of the term structure of interest rates is determined by an investor’s additional required interest rate in compensation for additional risks.

**liquidity-risk premium**—the additional return required by investors for securities that cannot be quickly converted into cash at a reasonably predictable price.

**long-term debt**—loans from banks or other sources that lend money for longer than 12 months.

**majority voting**—voting in which each share of stock allows the shareholder one vote

and each position on the board of directors is voted on separately. As a result, a majority of shares has the power to elect the entire board of directors.

**marginal tax rate**—the tax rate that would be applied to the next dollar of income.

**market risk**—see systematic risk.

**market segmentation theory**—the theory that the shape of the term structure of interest rates implies that the rate of interest for a particular maturity is determined solely by demand and supply for a given maturity. This rate is independent of the demand and supply for securities having different maturities.

**market value**—the value observed in the marketplace.

**marketable securities**—security investments (financial assets) the firm can quickly convert to cash balances. Also known as near cash or near-cash assets.

**maturity**—the length of time until the bond issuer returns the par value to the bondholder and terminates the bond.

**maturity-risk premium**—the additional return required by investors in longer-term securities to compensate them for the greater risk of price fluctuations on those securities caused by interest rate changes.

**modified internal rate of return (MIRR)**—the discount rate that equates the present value of the project’s future free cash flows with the terminal value of the cash inflows.

**money market**—all institutions and procedures that facilitate transactions for short-term instruments issued by borrowers with very high credit ratings.

**mortgage**—a loan to finance real estate where the lender has first claim on the property in the event the borrower is unable to repay the loan.

**mortgage bond**—a bond secured by a lien on real property.

**multinational corporation (MNC)**—a corporation with holdings and/or operations in more than one country.

**mutually exclusive projects**—projects that, if undertaken, would serve the same purpose. Thus, accepting one will necessarily mean rejecting the others.

**net fixed assets**—gross fixed assets minus the accumulated depreciation taken over the life of the assets.

**net income (net profit, or earnings available to common stockholders)**—the earnings available to the firm’s common and preferred stockholders.

**net present value (NPV)**—the present value of an investment’s annual free cash flows less the investment’s initial outlay.

**net present value profile**—a graph showing how a project’s NPV changes as the discount rate changes.

**net profit margin**—net income divided by sales. A ratio that measures the net income of the firm as a percent of sales.

**net working capital**—the difference between the firm’s current assets and its current liabilities.

**nominal (or quoted) rate of interest**—the interest rate paid on debt securities without an adjustment for any loss in purchasing power.

**nondiversifiable risk**—see systematic risk.

**operating expenses**—marketing and selling expenses, general and administrative expenses, and depreciation expense.

**operating income (earnings before interest and taxes)**—sales less the cost of goods sold less operating expenses.

**operating leverage**—results from operating costs that are fixed and do not vary with the level of firm sales.

**operating profit margin**—a firm’s operating profits divided by sales. This ratio serves as an overall measure of operating effectiveness.

**operating return on assets (OROA)**—the ratio of a firm’s operating profits divided by its total assets. This ratio indicates the rate of return being earned on the firm’s assets.

**operating risk**—risk driven by the mix of fixed versus variable costs the firm incurs to do business.

**operations management**—how effectively management is performing in the day-to-day operations in terms of how well management is generating revenues and controlling costs and expenses; in other words, how well is the firm managing the activities that directly affect the income statement?

**opportunity cost**—the cost of making a choice defined in terms of the next best alternative that is foregone.

**opportunity cost of funds**—the next-best rate of return available to the investor for a given level of risk.

**optimal capital structure**—the capital structure that minimizes the firm’s composite cost of capital (maximizes the common stock price) for raising a given amount of funds.

**optimal range of financial leverage**—the range of debt use in the firm’s capital structure that yields the lowest overall cost of capital for the firm.

**order point problem**—determining how low inventory should be depleted before it is reordered.

**order quantity problem**—determining the optimal order size for an inventory item

given its usage, carrying costs, and ordering costs.

**ordinary annuity**—an annuity where the cash flows occur at the end of each period.

**organized security exchanges**—formal organizations that facilitate the trading of securities.

**other current assets**—other short-term assets that will benefit future time periods, such as prepaid expenses.

**over-the-counter markets**—all security markets except organized exchanges. The money market is an over-the-counter market. Most corporate bonds also are traded in the over-the-counter market.

**paid-in capital**—the amount a company receives above par value from selling stock to investors.

**par value**—for a bond, par value is the stated amount that the firm is to repay when the bond comes due (matures); for a stock, par value is the arbitrary value a firm assigns to each share of stock when issued to investors. Any amount received from the stock sale that is above par value is paid-in-capital.

**partnership**—an association of two or more individuals joining together as co-owners to operate a business for profit.

**payable-through draft (PTD)**—a legal instrument that has the physical appearance of an ordinary check but is not drawn on a bank. A payable-through draft is drawn on and paid by the issuing firm. The bank serves as a collection point and passes the draft on to the firm.

**payback period**—the number of years it takes to recapture a project's initial outlay.

**payment date**—the date on which the company mails a dividend check to each investor of record.

**percent of sales method**—a method of financial forecasting that involves estimating the level of an expense, asset, or liability for a future period as a percent of the sales forecast.

**perfect capital markets**—markets in which information flows freely and market prices fully reflect all available information.

**permanent investment**—investments that the firm expects to hold longer than 1 year. The firm makes permanent investments in fixed and current assets.

**perpetuity**—an annuity with an infinite life.

**pledging accounts receivable**—a loan the firm obtains from a commercial bank or a finance company using its accounts receivable as collateral.

**portfolio beta**—the relationship between a portfolio's returns and the market returns.

It is a measure of the portfolio's nondiversifiable risk.

**preemptive right**—the right entitling the common shareholder to maintain his or her proportionate share of ownership in the firm.

**preferred stock**—a hybrid security with characteristics of both common stock and bonds. Preferred stock is similar to common stock in that it has no fixed maturity date, the nonpayment of dividends does not bring on bankruptcy, and dividends are not deductible for tax purposes. Preferred stock is similar to bonds in that dividends are limited in amount.

**preferred stockholders**—stockholders who have claims on the firm's income and assets after creditors, but before common stockholders.

**premium bond**—a bond that is selling above its par value.

**present value**—the value in today's dollars of a future payment discounted back to present at the required rate of return.

**present value factor**—the value of  $1/(1 + r)^n$  used as a multiplier to calculate an amount's present value.

**price/book ratio**—the market value of a share of the firm's stock divided by the book value per share of the firm's reported equity in the balance sheet. Indicates the market price placed on \$1 of capital that was invested by shareholders.

**price/earnings ratio**—the price the market places on \$1 of a firm's earnings. For example, if a firm has an earnings per share of \$2, and a stock price of \$30 per share, its price/earnings ratio is 15. ( $\$30 \div \$2$ ).

**primary market**—a market in which securities are offered for the first time for sale to potential investors.

**private placement**—a security offering limited to a small number of potential investors.

**privileged subscription**—the process of marketing a new security issue to a select group of investors.

**profitability index (PI) or benefit-cost ratio**—the ratio of the present value of an investment's future free cash flows to the investment's initial outlay.

**profit margins**—financial ratios (sometimes simply referred to as margins) that reflect the level of the firm's profits relative to its sales. Examples include the gross profit margin (gross profit divided by sales), operating profit margin (operating income divided by sales), and the net profit margin (net income  $\div$  sales).

**profit-retention rate**—the company's percentage of profits retained.

**project standing alone risk**—a project's risk ignoring the fact that much of this risk will be diversified away.

**protective provisions**—provisions for preferred stock that protect the investor's interest. The provisions generally allow for voting in the event of nonpayment of dividends, or they restrict the payment of common stock dividends if sinking-fund payments are not met or if the firm is in financial difficulty.

**proxy**—a means of voting in which a designated party is provided with the temporary power of attorney to vote for the signee at the corporation's annual meeting.

**proxy fight**—a battle between rival groups for proxy votes in order to control the decisions made in a stockholders' meeting.

**public offering**—a security offering where all investors have the opportunity to acquire a portion of the financial claims being sold.

**purchasing-power parity (PPP)**—a theory that states that exchange rates adjust so that identical goods cost the same amount regardless of where in the world they are purchased.

**pure play method**—a method for estimating a project's or division's beta that attempts to identify publicly traded firms engaged solely in the same business as the project or division.

**raw-materials inventory**—the basic materials purchased from other firms to be used in the firm's production operations.

**real rate of interest**—the nominal (quoted) rate of interest less any loss in purchasing power of the dollar during the time of the investment.

**real risk-free interest rate**—the required rate of return on a fixed-income security that has no risk in an economic environment of zero inflation.

**required rate of return**—minimum rate of return necessary to attract an investor to purchase or hold a security.

**residual dividend theory**—a theory that a company's dividend payment should equal the cash left after financing all the investments that have positive net present values.

**retained earnings**—cumulative profits retained in a business up to the date of the balance sheet.

**return on equity**—a firm's net income divided by its common book equity. This ratio is the accounting rate of return earned on the common stockholders' investment.

**revolving credit agreement**—an understanding between the borrower and the bank as to the amount of credit the bank will be legally obligated to provide the borrower.

**right**—a certificate issued to common stockholders giving them an option to purchase a stated number of new shares at a specified price during a 2- to 10-week period.

**risk**—potential variability in future cash flows.

**risk-adjusted discount rate**—a method of risk adjustment when the risk associated with the investment is greater than the risk involved in a typical endeavor. Using this method, the discount rate is adjusted upward to compensate for this added risk.

**risk-free rate of return**—the rate of return on risk-free investments. The interest rates on short-term U.S. government securities are commonly used to measure this rate.

**risk premium**—the additional return expected for assuming risk.

**safety stock**—inventory held to accommodate any unusually large and unexpected usage during delivery time.

**scenario analysis**—a simulation approach for gauging a project's risk under the worst, best, and most likely outcomes. The firm's management examines the distribution of the outcomes to determine the project's level of risk and then makes the appropriate adjustment.

**S-corporation**—a corporation that, because of specific qualifications, is taxed as though it were a partnership.

**seasoned equity offering, SEO**—the sale of additional stock by a company whose shares are already publicly traded.

**secondary market**—a market in which currently outstanding securities are traded.

**secured loans**—sources of credit that require security in the form of pledged assets. In the event the borrower defaults in payment of principal or interest, the lender can seize the pledged assets and sell them to settle the debt.

**security market line**—the return line that reflects the attitudes of investors regarding the minimum acceptable return for a given level of systematic risk associated with a security.

**semivariable costs**—costs composed of a mixture of fixed and variable components.

**sensitivity analysis**—a method for dealing with risk where the change in the distribution of possible net present values or internal rates of return for a particular project resulting from a change in one particular input variable is calculated. This is done by changing the value of one input variable while holding all other input variables constant.

**short-term notes (debt)**—amounts borrowed from lenders, mostly financial institutions such as banks, where the loan is to be repaid within 12 months.

**simple interest**—if you only earned interest on your initial investment, it would be referred to as simple interest.

**simulation**—a method for dealing with risk where the performance of the project under evaluation is estimated by randomly selecting observations from each of the distributions that affect the outcome of the project and continuing with this process until a representative record of the project's probable outcome is assembled.

**sinking-fund provision**—a protective provision that requires the firm periodically to set aside an amount of money for the retirement of its preferred stock. This money is then used to purchase the preferred stock in the open market or through the use of the call provision, whichever method is cheaper.

**slope coefficient**—the rate of change in the item being forecast with a linear equation and the change in sales.

**small, regular dividend plus a year-end extra**—a corporate policy of paying a small regular dollar dividend plus a year-end extra dividend in prosperous years to avoid the connotation of a permanent dividend.

**sole proprietorship**—a business owned by a single individual.

**spontaneous financing**—the trade credit and other accounts payable that arise spontaneously in the firm's day-to-day operations.

**spot exchange rate**—an exchange rate for a transaction that calls for immediate delivery.

**spot market**—cash market.

**stable dollar dividend per share**—a dividend policy that maintains a relatively stable dollar dividend per share over time.

**standard deviation**—a statistical measure of the spread of a probability distribution calculated by squaring the difference between each outcome and its expected value, weighting each value by its probability, summing over all possible outcomes, and taking the square root of this sum.

**statement of cash flows**—a statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities.

**stock dividend**—a distribution of shares of up to 25 percent of the number of shares currently outstanding, issued on a pro rata basis to the current stockholders.

**stock repurchase (stock buyback)**—the purchase of outstanding common stock by the issuing firm.

**stock split**—a stock dividend exceeding 25 percent of the number of shares currently outstanding.

**subordinated debenture**—a debenture that is subordinated to other debentures in terms of its payments in case of insolvency.

**syndicate**—a group of investment bankers who contractually assist in the buying and selling of a new security issue.

**systematic risk**—(1) the risk related to an investment return that cannot be eliminated through diversification. Systematic risk results from factors that affect all stocks. Also called market risk or nondiversifiable risk. (2) The risk of a project from the viewpoint of a well-diversified shareholder. This measure takes into account that some of the project's risk will be diversified away as the project is combined with the firm's other projects, and, in addition, some of the remaining risk will be diversified away by shareholders as they combine this stock with other stocks in their portfolios.

**tax shield**—the reduction in taxes due to the tax deductibility of interest expense.

**taxable income**—gross income from all sources, except for allowable exclusions, less any tax-deductible expenses.

**temporary investments**—a firm's investments in current assets that will be liquidated and not replaced within a period of 1 year or less. Examples include seasonal expansions in inventories and accounts receivable.

**tender offer**—a formal offer by the company to buy a specified number of shares at a predetermined and stated price. The tender price is set above the current market price in order to attract sellers.

**term structure of interest rates**—the relationship between interest rates and the term to maturity, where the risk of default is held constant.

**terminal-warehouse agreement**—a security agreement in which the inventories pledged as collateral are transported to a public warehouse that is physically removed from the borrower's premises. This is the safest (though costly) form of financing secured by inventory.

**terms of sale**—the credit terms identifying the possible discount for early payment.

**times interest earned**—a firm's operating profits divided by interest expense. This ratio measures a firm's ability to meet its interest payments from its annual operating earnings.

**total asset turnover**—a firm's sales divided by its total assets. This ratio is an overall measure of asset efficiency based on the relation between a firm's sales and the total assets.

**total revenue**—total sales dollars.

**trade credit**—credit made available by a firm's suppliers in conjunction with the acquisition of materials. Trade credit appears on the balance sheet as accounts payable.

**transaction loan**—a loan where the proceeds are designated for a specific purpose—for example, a bank loan used to finance the acquisition of a piece of equipment.

**treasury stock**—the firm's stock that has been issued and then repurchased by the firm.

**unbiased expectations theory**—the theory that the shape of the term structure of interest rates is determined by an investor's expectations about future interest rates.

**underwriter's spread**—the difference between the price the corporation raising money gets and the public offering price of a security.

**underwriting**—the purchase and subsequent resale of a new security issue. The risk of selling the new issue at a satisfactory (profitable) price is assumed (underwritten) by the investment banker.

**unsecured loans**—all sources of credit that have as their security only the lender's faith in the borrower's ability to repay the funds when due.

**unsystematic risk**—the risk related to an investment return that can be eliminated through diversification. Unsystematic risk is the result of factors that are unique to the particular firm. Also called company-unique risk or diversifiable risk.

**variable costs**—expenses that vary in total as output changes. Also called **direct costs**.

**venture capitalist**—an investment firm (or individual investor) that provides money to business start-ups.

**volume of output**—the number of units produced and sold for a particular period of time.

**weighted average cost of capital**—an average of the individual costs of financing used by the firm. A firm's weighted cost of capital is a function of (1) the individual costs of capital, and (2) the capital structure mix.

**working capital**—a concept traditionally defined as a firm's investment in current assets.

**working capital management**—the management of the firm's current assets and short-term financing.

**work-in-process inventory**—partially finished goods requiring additional work before they become finished goods.

**yield to maturity**—the rate of return a bondholder will receive if the bond is held to maturity.

**zero balance accounts (ZBA)**—a cash management tool that permits centralized control over cash outflow while maintaining divisional disbursing authority. Objectives are (1) to achieve better control over cash payments; (2) to reduce excess cash balances held in regional banks for disbursing purposes; and (3) to increase disbursing float.

**zero coupon bond**—a bond issued at a substantial discount from its \$1,000 face value and that pays little or no interest.