Glossary

Accounts payable The credit suppliers extend to the firm when it purchases items for its inventories.

Accounts payable deferral period The average period of time the firm uses to repay its trade creditors.

Accounts receivable Credit sales that have not yet been collected.

Accounts receivable turnover ratio The number of times that accounts receivable are rolled over each year.

Accredited investor An investor who is permitted to invest in certain types of higher-risk investments. Accredited investors include wealthy individuals, corporations, endowments, and retirement plans.

Accumulated depreciation The sum of all depreciation expenses that have been deducted from the firm's income statement in previous periods for the plant and equipment the firm currently has on its balance sheet.

Acid-test (quick) ratio A measure of firm liquidity that has current assets minus inventory, or "quick" assets, in the numerator and current liabilities in the denominator.

Agency costs The costs incurred by a firm's common stockholders when the firm's management makes decisions that are not in the shareholders' best interests but instead further the interests of the management of the firm.

Agency problem Conflicts that arise out of the separation of management and ownership of the firm.

American option An option that can be exercised at any time up through the contract's expiration date.

Amortized loan A loan that is paid off in equal periodic payments.

Amortizing bond A bond that is paid off in equal periodic payments, with those payments including part of the principal (par value) along with the interest.

Annual percentage rate (APR) The interest rate paid or earned in one year without compounding. It is calculated as the interest rate per period (for example, per month or week) multiplied by the number of periods during which compounding occurs during the year (m).

Annuity due A series of equal dollar payments for a specified period of time in which the payments occur at the beginning of each period.

Annuity A series of equal dollar payments for a specified period of time.

Annuity future value interest factor
The value $\left[\frac{(1+i)^n - 1}{i}\right]$, which is used as a multiplier to calculate the future value of an annuity.

Annuity present value interest factor
The value $\left[\frac{1 - \frac{1}{(1+i)^n}}{i}\right]$, which is used as a multiplier to calculate the present value of an annuity.

Arbitrage The process of buying and selling in more than one market to make riskless profits.

Arithmetic average return The sum of the set of returns divided by their number.

Asked rate The rate a bank or foreign exchange trader asks the customer to pay in home currency for foreign currency when the bank is selling and the customer is buying. Also known as the *selling rate*.

Average collection period The average number of days required to collect on the firm's credit sales.

Average tax rate The ratio of the tax liability divided by taxable income.

Balance sheet A financial statement that contains a summary of the firm's assets (everything of value the company owns), liabilities (the company's debts), and stockholders' equity (the money invested by the company owners).

Bank transaction loan An unsecured short-term bank credit made for a specific purpose.

Basis point One percent equals 100 basis points.

Basis risk Risk associated with imperfect hedging that arises because the asset underlying the futures contract is not identical to the asset underlying the firm's risk exposure.

Benchmarking Comparing the firm's current and proposed capital structures to those of a set of firms that are considered to be in similar lines of business and, consequently, subject to the same types of risk.

Beta coefficient A measure of the relationship between the returns of a security such as a share of common stock and the returns of the portfolio of all risky assets.

Bid rate The rate at which the bank buys the foreign currency from the customer by paying in home currency. The bid rate is also known as the *buying rate*.

Bid-asked spread The difference between the bid quote and asked quote.

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

Bond indenture A written agreement between the bond issuer and bondholders specifying the terms of the bond.

Bond rating The credit rating given to a bond, providing an indication of the creditworthiness of the bond.

Book value per share Common equity divided by the number of outstanding shares of common stock.

Buying rate The rate at which the bank buys the foreign currency from the customer by paying in its home currency. The buying rate is also known as the *bid rate*.

Call option A contract that gives its holder the right (but not the obligation) to purchase a given number of shares of stock or some other asset at a specified price within a given time period.

Call provision A provision that entitles the corporation to repurchase its bonds from its investors at stated prices over specified periods.

Capital Asset Pricing Model (CAPM) A model that describes the theoretical link between the expected rate of return on a risky security such as a share of stock and the security's risk as measured by its beta coefficient.

Capital budgeting The decision-making process used to analyze potential investments in fixed assets.

Capital Lease A long-term agreement to lease equipment over its useful life. With this type of lease contract the lessor acquires and finances the leased equipment and all other rights of ownership transfer to the lessee (the company that uses the leased equipment). These are sometimes referred to as finance or financial leases.

Capital market The market for long-term financial instruments.

Capital rationing A situation in which a firm's access to capital is limited, so it is unable to undertake all projects that have positive NPVs.

Capital structure The mix of long-term sources of funds used by the firm.

Cash budget A plan for a future period that details the sources of cash a firm anticipates receiving and the amounts and timing of cash it plans to spend.

Cash conversion cycle The operating cycle (the average collection period plus the inventory conversion period or days of sales

in inventories) less the accounts payable deferral period.

Cash dividend Cash paid directly to stockholders.

Cash flow from operations The portion of the firm's total cash flow resulting from its operating activities.

Cash flow statement A financial statement that reports cash received and cash spent by the firm over specific a period of time, usually one quarter of a year or a full year.

Cash return The monetary increase (decrease) in the value of an investment measured over a particular span of time.

Clean price The price of a bond before considering any accrued interest that the current owner is owed.

Collateral A borrower's pledge of specific property to a lender to secure repayment of a loan.

Commercial bank A financial institution that accepts demand deposits, makes loans, and provides other services to the public.

Commercial paper A money market security with a maturity of 1 to 270 days that is issued (sold) by large banks and corporations and that is backed by the issuing firm's promise to pay the face amount on the maturity date specified on the note.

Commodity futures A contract to buy or sell a stated commodity (such as wheat and corn as well as metals, wood products, and fibers) at a specified price at a specified future time.

Common stock A form of equity security that represents the residual ownership of the firm.

Compound interest The situation in which interest paid on the investment during the first period is added to the principal and, during the second period, interest is earned on the original principal plus the interest earned during the first period.

Compounding The process of determining the future value of a payment or series of payments when applying the concept of compound interest.

Constant dividend growth rate model A common stock valuation model that assumes that dividends will grow at a constant rate forever.

Conversion feature A feature of some debt that allows the bondholder to convert the bond into a prescribed number of shares of the firm's common stock.

Convertible bond A debt security that can be converted into a firm's stock at a prespecified price.

Corporate bond A bond issued by a corporation.

Corporation A business entity that legally functions separate and apart from its owners.

Correlation coefficient A measure of the degree to which the variation in one variable is related to the variation in another. The coefficient ranges from 21 for a perfectly negative relationship to 11 for perfectly positive dependence.

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. This rate must be adjusted for the fact that an increase in interest payments will result in lower taxes. The cost is based on the debt holders' opportunity cost of debt in the capital markets.

Cost of goods sold The cost of producing or acquiring the products or services that the firm sold during the period covered by an income statement.

Cost of preferred equity The rate of return that must be earned on the preferred stockholders' investment in order to satisfy their required rate of return. The cost is based on the preferred stockholders' opportunity cost of preferred stock in the capital markets.

Coupon interest rate The percentage of the par value of the bond that will be paid out annually in the form of interest, quoted as an annual percentage rate or APR.

Coupon rate The amount of interest paid per year, expressed as a percentage of the face value of the bond.

Credit default swap An insurance contract that pays off in the case of a credit event such as default or bankruptcy.

Credit risk or default risk The risk of loss as a result of default on a financial obligation.

Credit scoring A numerical evaluation of the creditworthiness of an individual borrower based on the borrower's current debts and history of making payments on a timely basis.

Credit spread The spread, or difference in interest rates (generally expressed in terms of basis points), between a corporate bond and a U.S. Treasury security of the same maturity. This is also referred to as the *spread or yield spread over Treasury bonds*.

Cross rate The exchange rate between two foreign currencies, neither of which is the currency of the domestic country.

Cumulative preferred stock Preferred stock that requires all past unpaid preferred stock dividends to 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.

Currency swap The exchange or trading of debt obligations whose payments are denominated in different currencies.

Current assets Cash plus other assets that the firm expects to convert to cash within 12 months or less.

Current liabilities The debts of the firm that must be paid within a period of 12 months or less.

Current ratio A measure of firm liquidity equal to the ratio of current assets to current liabilities.

Current yield The ratio of the annual interest payment to the bond's market price.

Date of record The date on which the company looks at its records to see who receives dividends.

Days' sales in inventory Inventory divided by cost of goods sold per day (cost of goods ÷ 365).

Debenture Any unsecured debt instrument.

Debt Money that has been borrowed and must be repaid. This includes such things as bank loans and bonds.

Debt ratio Total liabilities divided by total assets.

Debt securities Financial instruments that represent loans to corporations. Long-term debt securities are called bonds and can be bought and sold in the bond market.

Declaration date The date on which a dividend is formally declared by the board of directors.

Default-risk premium A premium reflecting the default risk of the note or bond.

Defined benefit plan A company retirement plan, such as a pension plan, in which a retired employee receives a specific amount based on his or her salary history and years of service.

Defined contribution plan A company retirement plan, such as a 401(k) plan, in which the employee elects to contribute some amount of his or her salary to the plan and takes responsibility for the investment decisions.

Delivery date The future date on which the actual payment of one currency in exchange for another takes place in a foreign exchange transaction.

Depreciation expense The allocation of the cost of the firm's long-lived assets (such as its plant and equipment) in the income statement over the useful lives of the assets.

Derivative contract A security whose value is *derived* from the value of another asset or security (which is referred to as the *underlying asset*).

Developed country Sometimes referred to as an industrialized country, where the term is used to identify those countries such as the United States, Great Britain, and France that have highly sophisticated and well-developed economies.

Direct foreign investment The physical investment, such as building a factory, that one country makes 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.

Dirty price Also referred to as the bond's invoice price, it is the price of a bond after consideration of any accrued interest that the current owner is owed; it is equal to the clean price plus accrued interest.

Discount bond A bond that sells at a discount below its par value.

Discount rate The interest rate used in the discounting process.

Discounted payback period The number of years required for a project's discounted cash flows to recover the initial cash outlay for an investment.

Discounting The inverse of compounding. This process is used to determine the present value of a future cash flow.

Discretionary financing needs (DFN) The total amount of financing a firm estimates it will need for a future period that will not be funded by the retention of earnings or by increases in the firm's accounts payable and accrued expenses.

Discretionary sources of financing Sources of financing that require explicit action by the firm's management. For example, the decision to borrow money from a bank is an example of discretionary financing, whereas the automatic financing of inventory purchases from an existing supplier that increases the firm's accounts payable is not a discretionary source of financing.

Diversifiable risk Risk that can be eliminated through diversification.

Diversification The reduction in risk that comes about by combining two or more risky assets into a portfolio where the individual assets are less than perfectly positively correlated.

Dividend clienteles Groups of investors who prefer the firm's cash distribution policy.

Dividend payout ratio The total dollar amount of dividends relative to the company's net income.

Dividend policy The firm's policy that determines how much cash it will distribute to its shareholders and when these distributions will be made.

Dividends The portion of a corporation's earnings that is distributed to its shareholders.

Dividends per share The per share cash distribution a firm pays for each share of stock.

Divisional WACC The cost of capital for a specific business unit or division.

DuPont method A method for decomposing the return on equity ratio into three components: net profit margin, total asset turnover, and an equity multiplier that reflects the use of debt financing.

Earnings before interest and taxes (EBIT) Revenues from sales minus the cost of goods sold and operating expenses. Also referred to as *net operating income*.

Earnings per share Net income divided by the number of common shares outstanding.

EBIT-EPS chart A graphic representation of the relationship between EPS and the level of firm EBIT.

EBIT-EPS indifference point The level of EBIT that produces the same level of EPS for two different capital structures.

EBITDA coverage ratio The ratio of the sum of EBIT plus depreciation expense (EBITDA) divided by interest plus annual before-tax principal payments (principal divided by 1 minus the firm's tax rate).

Effective annual rate (EAR) The annual compounded rate that produces the same return as the nominal, or stated, rate.

Efficient market A market in which prices quickly respond to the announcement of new information.

Efficient markets hypothesis (EMH) This hypothesis states that securities prices accurately reflect future expected cash flows and are based on all information available to investors.

Emerging market One located in an economy with low-to-middle per capita income. These countries constitute roughly 80 percent of the world's population and represent about a fifth of the world's economies. China and India are perhaps the best known and largest of the emerging-market economies.

Enterprise value The sum of the firm's market capitalization plus net debt.

Equity The ownership interest in a corporation. It is the stockholders' investment in the firm and the cumulative profits retained in the business up to the date of the balance sheet.

Equity risk premium The difference between returns of the riskier stock investments and the less risky investments in government securities.

Equity securities Financial instruments that represent ownership claims on a business. Equity securities for corporations are called shares of stock and can be bought and sold in the stock market.

Equivalent annual cost (EAC) The annuity cash flow amount that is equivalent to the present value of the project's costs.

Eurobond A bond issued in a country different from the one in whose currency 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.

European option An option that can be exercised only on its expiration date.

Ex-dividend date The date on 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.

Exchange rate The price of a foreign currency stated in terms of the domestic or home currency.

Exchange rate risk The risk that tomorrow's exchange rate will differ from today's rate.

Exchange-traded fund (ETF) An investment vehicle traded on stock exchanges much like a share of stock. The entity holds investments in assets that meet the investment objective of the entity (e.g., shares of stock of companies from emerging markets).

Exercise price The price at which the stock or asset may be purchased from the option writer in the case of a call or sold to the option writer in the case of a put; also called the *strike* or *striking price*.

Expansion project An investment proposal that increases the scope of the firm's operations, including the addition of both revenues and costs, but does not replace any existing assets or operations.

Expected rate of return The average of all possible rates of return, where each possible return is weighted by the probability that it might occur.

Expected value A probability-weighted average of all possible outcomes.

Face value or par value On the face of a bond, the stated amount that the firm is to repay on the maturity date.

Factor A financial institution that purchases accounts receivable from firms.

Favorable financial leverage When the firm's investments earn a rate of return (before taxes) that is greater than the cost of borrowing, this results in higher EPS and a higher rate of return on the firm's common equity.

Financial distress costs The costs incurred by a firm that cannot pay its bills (including

principal and interest on debt) in a timely manner.

Financial futures A contract to buy or sell an underlying asset such as Treasury securities, certificates of deposit, Eurodollars, foreign currencies, or stock indexes at a specified price at a specified future time.

Financial intermediaries Institutions whose business is to bring individuals and institutions with money to invest or lend together with other firms or individuals in need of money.

Financial leverage The magnifying effect of the use of debt financing on the rate of return earned on the equity invested in a firm.

Financial leverage effect The effect of using debt financing in a firm's capital structure; firm EPS increases when leverage is favorable and decreases when leverage is unfavorable.

Financial markets Mechanisms that allow people to easily buy and sell financial claims.

Financial ratios Accounting data restated in relative terms to identify some of the financial strengths and weaknesses of a company.

Financial structure The mix of sources of financing used by the firm to finance its assets. Commonly described using the ratios found by dividing each source of financing on the right-hand side of the firm's balance sheet by the sum of the firm's total liabilities plus owners' equity.

Fisher effect The relationship among the nominal rate of interest, the anticipated rate of inflation, and the real rate of interest.

Fixed asset turnover ratio A measure of the efficiency of a firm's use of its fixed assets equal to the ratio of sales to net fixed assets.

Fixed assets Those assets that the firm does not expect to sell or otherwise convert to cash within one year.

Float The difference between the cash balance shown on a firm's books and the available balance at the firm's bank.

Floating rate An interest rate on a loan agreement, such as a bond, that adjusts up or down depending on the movement of an agreed-on benchmark, such as LIBOR (London Interbank Offered Rate).

Floating-rate bond A bond that has a floating rate of interest.

Flotation costs The transaction costs incurred when a firm raises funds by issuing a particular type of security.

Foreign exchange (FX) market The market in which the currencies of various countries are traded.

Forward contract A contract wherein a price is agreed upon today for an asset to be sold in the future. These contracts are privately negotiated between the buyer and seller.

Forward exchange contract A contract that requires delivery on a specified future date of one currency in return for a specified amount of another currency.

Forward exchange rate The exchange rate agreed upon today for the delivery of currency at a future date.

Forward-spot differential The difference (premium or discount) between the forward and spot currency exchange rates for a country's currency.

Future value What a cash flow will be worth in the future.

Future value interest factor The value $(1 + i)_n$ used as a multiplier to calculate an amount's future value.

Futures contract A contract to buy or sell a stated commodity (such as soybeans or corn) or financial claim (such as U.S. Treasury bonds) at a specified price at a specified future time.

Futures margin The amount of money or collateral that must be provided to control credit or default risk on a futures contract; this margin is required to prevent default.

General partner A member of a general partnership or a member of a limited partnership who actually runs the business and faces unlimited liability for the firm's debts.

General partnership A partnership in which all of the partners are fully liable for the indebtedness incurred by the partnership.

Geometric or compound average returns The rate of return earned on an investment that incorporates consideration for the effects of compound interest.

Gross plant and equipment The sum of the historical costs of the plant and equipment owned by the firm.

Gross profit margin The ratio of gross profit (sales less cost of goods sold) divided by sales.

Growing perpetuity An annuity in which the payments grow at a constant rate from period to period over an infinite life.

Hedge fund An investment fund that is open to a limited range of investors (accredited investors) and that can undertake a wider range of investment and trading activities than can other types of investment funds that are open to the general public (e.g., mutual funds).

Hedging A strategy designed to minimize exposure to unwanted risk by taking a position in one market that offsets exposure to price fluctuations in an opposite position in another market.

Holding period return The rate of return earned by investing for a specific period of time, such as one year or one month.

Income statement The financial statement that includes the revenues the firm has earned, the expenses it has incurred to earn those revenues, and the profit it has earned over a specific period of time, usually a quarter of a year or a full year.

Incremental cash flow The change in a firm's cash flows that is a direct consequence of its having undertaken a particular project.

Independent investment project An investment project whose acceptance will not affect the acceptance or rejection of any other project.

Indirect cost Fixed cost.

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 for the expected rate of increase in the prices of goods and services in the economy over the term of the bond.

Initial public offering (IPO) The first time a company issues stock to the public. This occurs in the primary markets.

Insurance A contract that involves compensation for specific potential future losses in exchange for periodic payments and that provides for the transfer of the risk of a loss from one entity to another in exchange for a premium.

Interest rate parity A theory that relates the interest rates in two countries to the exchange rates of their currencies.

Interest rate swap The swapping or trading between two companies of fixed-rate interest payments for variable- or floating-rate interest payments.

Interest tax savings The reduction in income tax resulting from the tax deductibility of interest expense.

Interest-bearing debt ratio The ratio of interest-bearing debt (short- and long-term) to total assets.

Interest-rate risk The variability in a bond's value (risk) caused by changing interest rates.

Internal rate of return (IRR) The compound annual rate of return earned by an investment.

Internal sources of financing The retained earnings of a firm that can be reinvested in the firm.

International Fisher Effect (IFE) A theory that states that real rates of return are

the same across the world, with the difference in returns across the world resulting from different inflation rates.

Inventory Raw materials used to make the firm's products, goods in process, and finished goods that are ready for sale.

Inventory conversion period The number of days a firm uses to convert its inventory to cash or accounts receivable following a sale.

Inventory management The control of the firm's store of assets that are to be sold in the normal course of the firm's operations. The general categories of inventory include raw-materials inventory, work-in-process inventory, and finished-goods inventory.

Inventory turnover ratio A measure of the efficiency of a firm's use of its inventory equal to the ratio of cost of goods sold to inventory.

Investment bank A financial institution that raises capital, trades in securities, and manages corporate mergers and acquisitions.

Investment company A firm that invests the pooled funds of retail investors for a fee.

Junk (high-yield) bond Any bond rated BB or below.

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 adjusting for the exchange rate between the two currencies.

Level perpetuity An annuity with a constant level of payments over an infinite life.

Leveraged buyout firm A private equity firm that raises capital from individual investors and uses these funds, along with significant amounts of debt, to acquire controlling interests in operating companies.

Limited liability company (LLC) A business organizational form that blends elements of the partnership and corporate forms.

Limited partner A member of a limited partnership who is liable only up to the amount invested by that member.

Limited partnership A partnership in which one or more of the partners have limited liability that is restricted to the amount of capital they invest in the partnership.

Line of credit An informal agreement or understanding between the borrower and the bank about the maximum amount of credit that the bank will provide the borrower at any one time.

Liquidity The speed with which an asset can be converted into cash without loss of value.

Liquidity ratios Measures of the ability of a firm to pay its bills in a timely manner when they come due.

Liquidity-risk premium A premium required by investors for securities that cannot quickly be converted to cash at a reasonably predictable price.

Load fund A mutual fund that charges investors a sales commission called a *load*.

Loan amortization schedule A breakdown of the interest and principal payments on an amortized loan.

London Interbank Offered Rate (LIBOR) LIBOR is a daily rate that is based on the interest rates at which banks offer to lend in the London wholesale or interbank market (the market where banks loan each other money).

Long position A term used to refer to the ownership of a security, contract, or commodity. When someone owns a security he or she is said to be "long" on the security, such that when the price of the security rises, the individual profits.

Long-term debt Loans from banks and other lenders that have maturities longer than one year as well as bonds sold by the firm in the public markets.

Long-term financial plan A detailed estimate of a firm's sources and uses of financing for a period that extends three to five years into the future.

Majority voting Each share of stock allows the shareholder one vote, and each position on the board of directors is voted on separately.

Marginal tax rate The tax rate that the company will pay on its next dollar of taxable income.

Market portfolio The portfolio of all risky assets.

Market risk premium The difference in the expected rate of return on the market portfolio and the risk-free rate of return.

Market value The price that an asset would trade for in a competitive market.

Market value ratios Ratios used to compare the market value of a firm's shares to either the book value per share or the earnings per share.

Market-to-book ratio The ratio of the market value of a firm's equity (share price times the number of shares outstanding) to the book value of the firm's equity.

Market's required yield The rate of return on the preferred stock's contractually promised dividend. The market's required yield on a preferred stock is analogous to the market's required yield to maturity on a bond.

Marking to market Transferring daily gains or losses from a firm's futures contracts to or from its margin account.

Maturity The date when a debt must be repaid.

Maturity-risk premium A premium that reflects the added price volatility that accompanies bonds with longer terms to maturity.

Modified internal rate of return (MIRR) The compound annual rate of return earned by an investment whose cash flows have been moved through time so as to eliminate the problem of multiple IRRs. For example, all negative cash flows after Year 0 are discounted back to Year 0 using the firm's required rate of return, and then the IRR is determined for this modified cash flow stream.

Money market The financial market for short-term debt securities (maturing in one year or less).

Money market securities Short-term, low-risk debt instruments that can be sold easily and with very low risk of loss.

Mortgage bond A bond secured by a lien on real property.

Multinational corporation (MNC) A company that has control over direct foreign investments in more than one country.

Mutual fund A professionally managed investment company that pools the investments of many individuals and invests them in stocks, bonds, and other types of securities.

Mutually exclusive projects Related or dependent investment proposals where the acceptance of one proposal means the rejection of the other.

Net asset value (NAV) For an entity such as a mutual fund, the difference between the current market value of its assets and the value of its liabilities.

Net debt The book value of interest-bearing debt less excess cash.

Net income The income that a firm has after subtracting costs and expenses from total revenues.

Net Lease A lease agreement in which the lessee is responsible for the paying a portion of all the taxes, fees, and maintenance costs for the leased property or equipment in addition to paying rent. This type of agreement is commonly used with commercial real estate.

Net operating income The firm's profits from its ongoing operations—before it makes interest payments and pays its taxes. Also

referred to as *earnings before interest and taxes (EBIT)*.

Net plant and equipment The cumulative historical costs of plant and equipment owned by the firm (gross plant and equipment) less the accumulated depreciation expense that has been charged against those assets over their useful lives.

Net present value (NPV) The difference in the present value of an investment proposal's future cash flows and the initial cash outlay. This difference is the expected increase in the value of the firm due to the acceptance of the project.

Net profit margin Net income divided by sales.

Net working capital The difference between the firm's current assets and current liabilities.

No-load fund A mutual fund that doesn't charge a commission.

Nominal cash flows Cash flows that account for the effects of inflation.

Nominal (or quoted) interest rate The stated rate of interest that is unadjusted for inflation.

Nominal rate of interest The rate of interest that is observed in financial markets and that incorporates consideration for inflation.

Non-amortizing bond A bond that pays only interest.

Nondiversifiable risk Risk that cannot be eliminated through diversification.

Note A term used to refer to indebtedness. Notes generally have a maturity of between 1 and 10 years when originally issued.

Notes payable Short-term notes or loans that must be repaid in one year or less.

Notional principal The nominal or face amount on a swap agreement. This is the principal used to calculate payments for swap contracts, but because this principal does not change hands, it is commonly referred to as the notional amount of the contract.

NPV profile A plot of multiple NPV estimates calculated using a succession of different discount rates. This profile illustrates when there are multiple IRRs—that is, where the NPV is equal to zero for more than one discount rate.

Open market repurchase A method of repurchasing the firm's stock whereby the firm acquires the stock on the open market, often buying a relatively small number of shares every day, at the going market price.

Operating cycle The period of time (usually measured in days) that elapses from the time the firm acquires an item of inventory until that item has been sold and cash has been collected.

Operating Lease A contract whereby the lessor permits the user or lessee to use of an asset for a period of time which is shorter than the economic life of the asset without any transfer of ownership rights.

Operating profit margin The ratio of net operating income to sales.

Operating return on assets (OROA) ratio A measure of the return earned by a firm's operations, or net operating income, divided by total assets.

Opportunity cost The value of the next best alternative that is foregone as a result of making a decision.

Optimal capital structure The mix of financing sources in the capital structure that maximizes shareholder value.

Option contract The right, but not the obligation, to buy or sell something (e.g., 100 shares of stock for a stock option) at a specified price within a specified period of time.

Option expiration date The date on which an option contract expires.

Option premium The price paid for an option.

Option writing The process of *selling* puts and calls.

Ordinary annuity A series of equal dollar payments for a specified period of time in which the payments occur at the end of each period.

Over-the-counter market An informal, electronic network where approximately 35,000 securities not traded on the major exchanges are bought and sold.

Paid-in capital The money contributed to a corporation by its stockholders in addition to the par value of the firm's stock. Sometimes called *paid-in capital above par*.

Par or face value of a bond On the face of a bond, the stated amount that the firm is to repay on the maturity date.

Par value The stated value of a bond or share of stock at the time of issue.

Partnership The joining together of two or more individuals as co-owners to operate a business for profit.

Payback period The number of years of future cash flows needed to recover the initial investment in a proposed project.

Payment date The date on which the company mails a dividend check to each investor of record.

Percent-of-sales method A financial forecasting technique that uses the proportion of the item being forecast (e.g., accounts receivable) to the level of firm sales as the basis for predicting the future level of the item.

Permanent investments in assets Investments in assets that the firm expects to hold for a period longer than one year. These include the firm's minimum level of current assets, such as accounts receivable and inventories, as well as fixed assets.

Permanent sources of financing Sources of financing that are expected to be used by the firm for an extended period of time, such as an intermediate-term loan, bonds, or common equity.

Perpetuity An annuity with an infinite life.

Political risk The potential for losses that can occur when investing in foreign countries where political decisions can result in losses of property.

Portfolio beta The beta coefficient of a portfolio of different investments.

Preferred stock A form of equity security that holds preference over common stock in terms of the right to the distribution of cash (dividends) and the right to the distribution of proceeds in the event of the liquidation and sale of the issuing firm.

Premium bond A bond that sells at a premium above its par value.

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

Present value interest factor The value $[1/(1 + i)_n]$ used as a multiplier to calculate a future payment's present value.

Price-earnings (PE) ratio The ratio of price per share of common stock divided by earnings per share.

Primary market A financial market where new security issues are initially bought and sold.

Principle of self-liquidating debt A guiding rule of thumb for managing firm liquidity that calls for financing permanent investments in assets with permanent sources of financing and temporary investments in assets with temporary sources of financing.

Private equity firm A financial intermediary that invests in equities that are not traded on the public capital markets.

Private market transaction A loan that involves only the two parties.

Pro forma balance sheet A forecast of each of the elements of a firm's balance sheet.

Pro forma income statement A forecast of each of the elements of a firm's income statement.

Probability distribution For an investment's rate of return, a description of all

possible rates of return from the investment, along with the associated probability for each outcome.

Profitability index (PI) The ratio of the present value of the expected future cash flows for an investment proposal (discounted using the required rate of return for the project) divided by the initial investment in the project.

Profits Another term for income.

Proprietary trading Trading in which a bank uses its capital to make speculative bets on derivatives and securities.

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.

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.

Put option A contract that gives its holder the right (but not the obligation) to sell a given number of shares of stock or some other asset at a specified price within a given time period.

Quality of earnings ratio The ratio of cash flow from operations divided by net income.

Range of earnings chart Same as EBIT-EPS chart.

Rate of return See Holding period return.

Real cash flows Cash flows that would occur in the absence of any inflation.

Real options Opportunities that allow for the alteration of the project's cash flow stream after the project is initiated (e.g., changing the product mix, level of output, or mix of inputs).

Real rate of interest The nominal rate of interest less any loss in purchasing power of the dollar during the time of the investment.

Real risk-free rate of interest The risk-free return in a period of zero inflation.

Replacement investment An investment proposal that is a substitute for an existing investment.

Residual dividend payout policy A payout policy whereby the company's dividend payment should equal the cash left after financing all the investments that have positive net present values.

Retained earnings The accumulation of prior-year net income that was retained and reinvested in the firm (i.e., not paid in dividends).

Return on equity A measure of the rate of return earned on the common shareholders' investment in the firm equal to net income divided by common equity.

Revenues Sales recognized for the period and recorded in the firm's income statement.

Risk premium The amount by which the required rate of return exceeds the risk-free rate of interest.

Risk profile The concept of a firm's "appetite" for assuming risk.

Risk-free rate of return The rate of return earned by investing in a security that always pays the promised rate of return (without risk).

Rule of 72 A method for estimating the time it takes for an amount to double in value. To determine the approximate time it takes for an amount to double in value, 72 is divided by the annual interest rate.

Scenario analysis Analysis that allows the financial manager to simultaneously consider the effects of changes in the estimates of multiple value drivers on the investment opportunity's net present value.

Secondary market The financial market where previously issued securities such as stocks and bonds are bought and sold.

Secured bond A bond that is backed or secured by pledged assets or collateral to reduce the risk associated with lending.

Secured current liabilities Loans that involve the pledge of specific assets as collateral in the event the borrower defaults on the payment of principal or interest.

Security A negotiable instrument that represents a financial claim that has value. Securities are broadly classified as debt securities (bonds) and equity securities (shares of common stock).

Security market line A graphical representation of the Capital Asset Pricing Model.

Self-insurance A risk management approach where the entity sets aside a sum of money as protection against potential future loss rather than purchasing an insurance policy.

Selling rate The rate a bank or foreign exchange trader asks the customer to pay in home currency for foreign currency when the bank is selling and the customer is buying. The selling rate is also known as the *asked rate*.

Semi-strong-form efficient market A market in which all publicly available information is quickly and accurately reflected in prices.

Sensitivity analysis The process of determining how the distribution of possible net present values or internal rates of return for a particular project is affected by a change in one particular value driver.

Share or stock repurchase Also called a stock buyback, the repurchase of common stock by the issuing firm for any of a variety of reasons, resulting in a reduction of shares outstanding.

Shareholders The owners of the firm; those who own shares of stock in a corporation.

Shares Units of ownership.

Short position A term used to refer to the fact that you have sold a security, contract, or commodity. A short position is exactly the opposite of a long position, such that when the price of the security goes up, the holder of the short position loses money.

Short-term financial plan A forecast of a firm's sources of cash and planned uses of cash spanning the next 12 months or less.

Simple arbitrage Trading to eliminate exchange rate differentials across the markets for a single currency—for example, across the New York and London markets.

Simple interest The interest earned on the principal.

Simulation analysis The process of imitating the performance of a risky investment project through repeated evaluations, usually using a computer. This type of experimentation is designed to capture the critical realities of the decision-making situation.

Sole proprietorship A business owned by a single individual.

Source of cash Any activity that brings cash into the firm, such as when the firm sells goods and services or sells an old piece of equipment that it no longer needs.

Spontaneous sources of financing Sources of financing that arise naturally out of the course of doing business and that do not call for an explicit financing decision each time the firm uses them.

Spot contract An exchange in which the buyer agrees to purchase something, the seller agrees to sell it for a specified price, and the exchange is completed at the same time.

Spot exchange rate The ratio of a home currency and foreign currency in which the transaction calls for immediate delivery.

Spread over Treasury bonds or yields The spread, or difference in interest rates (generally expressed in terms of basis points), between a corporate bond and a U.S. Treasury security of the same maturity. Also referred to as the *credit spread* and the *yield spread*.

Standard deviation The square root of the variance.

Stock dividend The 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 split A stock dividend exceeding 25 percent of the number of shares currently outstanding.

Stockholders The owners of the corporation's stock. The corporation is legally owned by its current set of stockholders, or owners, who elect a board of directors.

Stockholders' equity The sum of the par value of common stock plus paid-in capital plus retained earnings. This quantity is sometimes referred to as the *book value of the firm's equity*.

Strategic plan A general description of the firm, its products and services, and how it plans to compete with other firms in order to sell those products and services.

Strike price The price at which the stock or asset may be purchased from the option writer in the case of a call or sold to the option writer in the case of a put; also called the *exercise price*.

Strong-form efficient market A market in which even private information is fully and quickly reflected in market prices.

Subordinated debenture A debenture that is subordinated to other debentures in being paid in case of insolvency.

Sunk costs Costs that have already been incurred.

Swap contract An agreement in which two parties agree to exchange one set of payments for another. For example, the holder of a stream of fixed-interest-rate payments on a loan might exchange them for variable-interest-rate payments on a like-size loan.

Syndicate A group of investment bankers that are invited to help buy and resell the bond issue.

Systematic risk See Nondiversifiable risk.

Taxable income Firm revenues for the period less all tax-deductible expenses (such as cost of goods sold, operating expenses, and interest expense for the period).

Temporary investments in assets Investments in current assets—that is, those that will be liquidated and not replaced within the current year—including cash and marketable securities, accounts receivable, and seasonal fluctuations in inventories. Also referred to simply as *temporary assets*.

Temporary sources of financing Sources of financing that typically consist of current liabilities the firm incurs on a discretionary basis. Examples include unsecured bank loans and commercial paper (which is simply unsecured promissory notes with maturities of 1 to 270 days that the firm sells in the money market) as well as short-term loans that are secured by the firm's inventories or accounts receivable.

Tender offer A formal offer by the company to buy back 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 Also called the yield curve, which is the relationship between interest rates and the term to maturity, where the risk of default is held constant.

Terms of sale The time period until payment must be made, any discount for early payment.

Timeline A linear representation of the timing of cash flows.

Times interest earned ratio A measure of the ability of the firm to pay its interest expense equal to the ratio of net operating income divided by interest expense.

Total asset turnover (TATO) ratio A measure of the efficiency of a firm's use of its total assets equal to the ratio of sales to total assets.

Total assets The total of current and long-term assets recorded in the firm's balance sheet.

Total liabilities The total amount of money the firm owes its creditors (including the firm's banks and other creditors).

Total stockholders' equity Total assets less total liabilities.

Trade credit A type of account payable that arises when a firm provides goods or services to a customer with an agreement to bill the customer later.

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 Stock that has been bought back by the issuing company.

Trend analysis The use of historical ratios compared to a firm's current-period ratios to indicate whether the firm's financial condition is improving or deteriorating.

Unfavorable financial leverage When the firm's investments earn a rate of return (before taxes) that is less than the cost of borrowing, this results in lower EPS and a lower rate of return on the firm's common equity.

Unsecured current liabilities Debts of the company that are due and payable within a period of one year and that are secured only by the promise of the firm to repay the debt.

Unsubordinated debenture A debenture that is unsubordinated to other debentures in being paid in case of insolvency.

Unsystematic risk See Diversifiable risk.

Use of cash Any activity that causes cash to leave the firm, such as the payment of taxes or payments made to stockholders, creditors, and suppliers.

Value drivers The primary determinants of an investment's cash flows and its performance (e.g., number of units sold and cost per unit to produce).

Variance The average of the squared differences between the possible rates of return and the expected rate of return. As such, the variance is a measure of the average squared difference in possible and expected rates of return.

Venture capital firm An investment company that raises money from accredited investors and uses the proceeds to invest in new start-up companies.

Volatility Another term for the fluctuation in returns.

Weak-form efficient market A market in which current prices quickly and accurately reflect information that can be derived from patterns in past security prices and trading volumes.

Working capital management Management of day-to-day operations and decisions related to working capital and short-term financing.

Yield curve Also called the term structure of interest rates, which is the relationship between interest rates and the term to maturity, where the risk of default is held constant.

Yield spread The spread, or difference in interest rates (generally expressed in terms of basis points), between a corporate bond and a U.S. Treasury security of the same maturity. Also referred to as the *spread over Treasury bonds or* the *credit spread*.

Yield to maturity The promised rate of return to an investor who holds the bond until maturity, assuming the bond issuer does not default on any of the interest and principal payments.

Zero-coupon bond A bond that pays no interest to the lender but instead is issued at a substantial discount from its face value. The lender realizes its interest when the bond matures and the issuer repays its full face value to the lender.