Glossary

A

after-acquired property clause A requirement in a bond issue stipulating that any new equipment purchased after the issue be placed under the original mortgage.

aftermarket The market for a new security offering immediately after it is sold to the public.

agency theory This theory examines the relationship between the owners of the firm and the managers of the firm. While management has the responsibility for acting as the agent for the stockholders in pursuing their best interests, the key question considered is: How well does management perform this role?

agent One who sells, or "places," an asset for another party. An agent works on a commission or fee basis. Investment bankers sometimes act as agents for their clients in private placements.

aging of accounts receivable Analyzing accounts by the amount of time they have been on the books.

American Depository Receipts (ADR) These receipts represent the ownership interest in a foreign company's common stock. The shares of the foreign company are put in trust in a major U.S. bank. The bank, in turn, issues its depository receipts to the American stockholders of the foreign firm. Many ADRs are listed on the NYSE and many more are traded in the over-the-counter market.

American Stock Exchange (AMEX) The second largest national physically located security exchange in the United States.

annual percentage rate (APR) A measure of the *effective* rate on a loan. One uses the actuarial method of compound interest when calculating the APR.

annuity A series of consecutive payments or receipts of equal amount.

articles of incorporation A document that establishes a corporation and specifies the rights and limitations of the business entity.

articles of partnership An agreement between the partners in a business that specifies the ownership interest of each, the methods of distributing profits, and the means for withdrawing from the partnership.

asset-backed securities Public offerings backed by receivables as collateral. Essentially, a firm factors (sells) its receivables in the securities markets.

asset depreciation range This represents the expected physical life of an asset. Generally, the midpoint of the ADR is utilized to determine what class an asset falls into for depreciation purposes.

asset utilization ratios A group of ratios that measures the speed at which the firm is turning over or utilizing its assets. They measure inventory turnover, fixed asset turnover, total asset turnover, and the average time it takes to collect accounts receivable.

assignment The liquidation of assets without going through formal court procedures. In order to affect an assignment, creditors must agree on liquidation values and the relative priority of claims.

automated clearinghouse (ACH) An ACH transfers information between one financial institution and another and from account to account via computer tape. There are approximately 30 regional clearinghouses throughout the United States that claim the membership of over 10,000 financial institutions.

average collection period The average amount of time accounts receivable have been on the books. It may be computed by dividing accounts receivable by average daily credit sales.

B

balance of payments The term refers to a system of government accounts that catalogs the flow of economic transactions between countries.

balance sheet A financial statement that indicates what assets the firm owns and how those assets are financed in the form of liabilities or ownership interest.

banker's acceptance Short-term securities that frequently arise from foreign trade. The acceptance is a draft that is drawn on a bank for approval for future payment and is subsequently presented to the payer.

bank holding company A legal entity in which one key bank owns a number of affiliate banks as well as other nonbanking subsidiaries engaged in closely related activities.

bankruptcy The market value of a firm's assets are less than its liabilities, and the firm has a negative net worth. The term is also used to describe in-court procedures associated with the reorganization or liquidation of a firm.

basic earnings per share Earnings per share unadjusted for dilution.

basis point One basis point equals 1/100 of 1 percent.

bear market A falling or lethargic stock market. The opposite of a bull market.

best efforts A distribution in which the investment banker agrees to work for a commission rather than actually underwriting (buying) the issue for resale. It is a procedure that is used by smaller investment bankers with relatively unknown companies. The investment banker is not directly taking the risk for distribution.

beta A measure of the volatility of returns on an individual stock relative to the market. Stocks with a beta of 1.0 are said to have risk equal to that of the market (equal volatility). Stocks with betas greater than 1.0 have more risk than the market, while those with betas of less than 1.0 have less risk than the market.

blanket inventory lien A secured borrowing arrangement in which the lender has a general claim against the inventory of the borrower.

bond ratings Bonds are rated according to risk by Standard & Poor's and Moody's Investor Service. A bond that is rated Aaa by Moody's has the lowest risk, while a bond with a C rating has the highest risk. Coupon rates are greatly influenced by a corporation's bond rating.

book-entry transactions A transaction in which no actual paper or certificate is created. All transactions simply take place on the books via computer entries.

book value (See net worth.)

brokers Members of organized stock exchanges who have the ability to buy and sell securities on the floor of their respective exchanges. Brokers act as agents between buyers and sellers.

bull market A rising stock market. There are many complicated interpretations of this term, usually centering on the length of time that the market should be rising in order to meet the criteria for classification as a bull market. For our purposes, a bull market exists when stock prices are strong and rising and investors are optimistic about future market performance.

business risk The risk related to the inability of the firm to hold its competitive position and maintain stability and growth in earnings.

C

call option An option to buy securities at a set price over a specified period of time.

call premium The premium paid by a corporation to call in a bond issue before the maturity date.

call provision Used for bonds and some preferred stock. A call allows the corporation to retire securities before maturity by forcing the bondholders to sell bonds back to it at a set price. The call provisions are included in the bond indenture.

capital Sources of long-term financing that are available to the business firm.

capital asset pricing model A model that relates the risk-return trade-offs of individual assets to market returns. A security is presumed to receive a risk-free rate of return plus a premium for risk.

capital lease A long-term, noncancelable lease that has many of the characteristics of debt. Under *SFAS No. 13,* the lease obligation must be shown directly on the balance sheet.

capital markets Competitive markets for equity securities or debt securities with maturities of more than one year. The best examples of capital market securities are common stock, bonds, and preferred stock.

capital rationing Occurs when a corporation has more dollars of capital budgeting projects with positive net present values than it has money to invest in them. Therefore, some projects that should be accepted are excluded because financial capital is rationed.

capital structure theory A theory that addresses the relative importance of debt and equity in the overall financing of the firm.

carrying costs The cost to hold an asset, usually inventory. For inventory, carrying costs include such items as interest, warehousing costs, insurance, and material-handling expenses.

cash budget A series of monthly or quarterly budgets that indicate cash receipts, cash payments, and the borrowing requirements for meeting financial requirements. It is constructed from the pro forma income statement and other supportive schedules.

cash discount A reduction in the invoice price if payment is made within a specified time period. An example would be 2/10, net 30.

cash flow A value equal to income after taxes plus noncash expenses. In capital budgeting decisions, the usual noncash expense is depreciation.

cash flow cycle The pattern in which cash moves in and out of the firm. The primary consideration in managing the cash flow cycle is to ensure that inflows and outflows of cash are properly synchronized for transaction purposes.

cash flows from financing activities Cash flow that is generated (or reduced) from the sale or repurchase of securities or the payment of cash dividends. It is the third section presented in the statement of cash flows.

cash flows from investing activities Cash flow that is generated (or reduced) from the sale or purchase of long-term securities or plant and equipment. It is the second section presented in the statement of cash flows.

cash flows from operating activities Cash flow information that is determined by adjusting net income for such items as depreciation expense, changes in current assets and liabilities, and other items. It is the first section presented in the statement of cash flows.

certificates of deposit A certificate offered by banks, savings and loans, and other financial institutions for the deposit of funds at a given interest rate over a specified time period.

coefficient of correlation The degree of associated movement between two or more variables. Variables that move in the same direction are said to be positively correlated, while negatively correlated variables move in opposite directions.

coefficient of variation A measure of risk determination that is computed by dividing the standard deviation for a series of numbers by the expected value. Generally, the larger the coefficient of variation, the greater the risk.

combined leverage The total or combined impact of operating and financial leverage.

commercial paper An unsecured promissory note that large corporations issue to investors. The minimum amount is usually $25,000.

common equity The common stock or ownership capital of the firm. Common equity may be supplied through retained earnings or the sale of new common stock.

common stock Represents the ownership interest of the firm. Common stockholders have the ultimate right to control the business.

common stock equity The ownership interest in the firm. It may be represented by new shares or retained earnings. The same as net worth.

common stock equivalent Warrants, options, and any convertible securities.

compensating balances A bank requirement that business customers maintain a minimum average balance. The required amount is usually computed as a percentage of customer loans outstanding or as a percentage of the future loans to which the bank has committed itself.

composition An out-of-court settlement in which creditors agree to accept a fractional settlement on their original claim.

compounded semiannually A compounding period of every six months. For example, a five-year investment in which interest is compounded semiannually would indicate an n value equal to 10 and an i value at one-half the annual rate.

conglomerate A corporation that is made up of many diverse, often unrelated divisions. This form of organization is thought to reduce risk, but may create problems of coordination.

consolidation The combination of two or more firms, generally of equal size and market power, to form an entirely new entity.

contribution margin The contribution to fixed costs from each unit of sales. The margin may be computed as price minus variable cost per unit.

conversion premium The market price of a convertible bond or preferred stock minus the security's conversion value.

conversion price The conversion ratio divided into the par value. The price of the common stock at which the security is convertible. An investor would usually not convert the security into common stock unless the market price were greater than the conversion price.

conversion ratio The number of shares of common stock an investor will receive if he or she exchanges a convertible bond or convertible preferred stock for common stock.

conversion value The conversion ratio multiplied by the market price per share of common stock.

convertible Eurobonds Convertible Eurobonds are dollar-denominated and sold primarily in Western European countries. They have the safety of a bond but the chance to grow with U.S. stock prices since they are convertible into a U.S. firm's stock.

convertible exchangeable preferred A form of preferred stock that allows the company to force conversion from convertible preferred stock into convertible debt. This can be used to allow the company to take advantage of falling interest rates or to allow the company to change aftertax preferred dividends into tax-deductible interest payments.

convertible security A security that may be traded into the company for a different form or type of security. Convertible securities are usually bonds or preferred stock that may be exchanged for common stock.

corporate financial markets Markets in which corporations, in contrast to governmental units, raise funds.

corporate stock repurchase A corporation may repurchase its shares in the market as an alternative to paying a cash dividend. Earnings per share will go up, and, if the price-earnings ratio remains the same, the stockholder will receive the same dollar benefit as through a cash dividend. A corporation may also justify the repurchase of its stock because it is at a very low price or to maintain constant demand for the shares. Reacquired shares may be used for employee options or as part of a tender offer in a merger or acquisition. Firms may also reacquire part of their shares as a protective device against being taken over as a merger candidate.

corporation A form of ownership in which a separate legal entity is created. A corporation may sue or be sued, engage in contracts, and acquire property. It has a continual life and is not dependent on any one stockholder for maintaining its legal existence. A corporation is owned by stockholders who enjoy the privilege of limited liability. There is, however, the potential for double taxation in the corporate form of organization: the first time at the corporate level in the form of profits, and again at the stockholder level in the form of dividends.

cost-benefit analysis A study of the incremental costs and benefits that can be derived from a given course of action.

cost of capital The cost of alternative sources of financing to the firm. (Also see weighted average cost of capital.)

cost of goods sold The cost specifically associated with units sold during the time period under study.

cost of ordering The cost component in the inventory decision model that represents the expenditure for acquiring new inventory.

coupon rate The actual interest rate on the bond, usually payable in semiannual installments. The coupon rate normally stays constant during the life of the bond and indicates what the bondholder's annual dollar income will be.

creditor committee A committee set up to run the business while an out-of-court settlement is reached.

credit terms The repayment provisions that are part of a credit arrangement. An example would be a 2/10, net 30 arrangement in which the customer may deduct 2 percent from the invoice price if payment takes place in the first 10 days. Otherwise, the full amount is due.

cross rates The relationship between two foreign currencies expressed in terms of a third currency (the dollar).

cumulative preferred stock If dividends from one period are not paid to the preferred stockholders, they are said to be in arrears and are then added to the next period's dividends. When dividends on preferred stock are in arrears, no dividends can legally be paid to the common stockholders. The cumulative dividend feature is very beneficial to preferred stockholders since it assures them that they will receive all dividends due before common stockholders can get any.

cumulative voting Allows shareholders more than one vote per share. They are allowed to multiply their total shares by the number of directors being elected to determine their total number of votes. This system enables minority shareholders to elect directors even though they do not have 51 percent of the vote.

currency futures contract A futures contract that may be used for hedging or speculation in foreign exchange.

current cost accounting One of two methods of inflation-adjusted accounting approved by the Financial Accounting Standards Board in 1979. Financial statements are adjusted to the present, using current cost data, rather than an index. This optional information may be shown in the firm's annual report.

current yield The yearly dollar interest or dividend payment divided by the current market price.

D

Data Universal Number System (D-U-N-S) A system in which a unique nine-digit code is assigned by Dun & Bradstreet to each business in its information base.

dealer paper A form of commercial paper that is distributed to lenders through an intermediate dealer network. It is normally sold by industrial companies, utility firms, or financial companies too small to have their own selling network.

dealers Participants in the market who transact security trades over the counter from their own inventory of stocks and bonds. They are often referred to as market makers, since they stand ready to buy and sell their securities at quoted prices.

debenture A long-term unsecured corporate bond. Debentures are usually issued by large firms having excellent credit ratings in the financial community.

debt utilization ratios A group of ratios that indicate to what extent debt is being used and the prudence with which it is being managed. Calculations include debt to total assets, times interest earned, and fixed charge coverage.

decimalization The statement of quotes in decimals rather than fractions.

decision tree A tabular or graphical analysis that lays out the sequence of decisions that are to be made and highlights the differences between choices. The presentation resembles branches on a tree.

deferred annuity An annuity that will not begin until some time period in the future.

deflation Actual declining prices.

degree of combined leverage (DCL) A measure of the total combined effect of operating and financial leverage on earnings per share. The percentage change in earnings per share is divided by the percentage change in sales at a given level of operation. Other algebraic statements are also used, such as Formula 5–7 and that in footnote 3 in Chapter 5.

degree of financial leverage (DFL) A measure of the impact of debt on the earnings capability of the firm. The percentage change in earnings per share is divided by the percentage change in earnings before interest and taxes at a given level of operation. Other algebraic statements are also used, such as Formula 5–5.

degree of operating leverage (DOL) A measure of the impact of fixed costs on the operating earnings of the firm. The percentage change in operating income is divided by the percentage change in volume at a given level of operation. Other algebraic statements are also used, such as Formula 5–3 and that in footnote 2 in Chapter 5.

depreciation The allocation of the initial cost of an asset over its useful life. The annual expense of plant and equipment is matched against the revenues that are being produced.

depreciation base The initial cost of an asset that is multiplied by the appropriate annual depreciation percentage in Table 12–9 to determine the dollar depreciation.

derivative securities These have a value derived from an underlying security such as common stock or a government bond.

diluted earnings per share EPS adjusted for all potential dilution from the issuance of any new shares of common stock arising from convertible bonds, convertible preferred stock, warrants, or any other options outstanding.

dilution of earnings This occurs when additional shares of stock are sold without creating an immediate increase in income. The result is a decline in earnings per share until earnings can be generated from the funds raised.

direct paper A form of commercial paper that is sold directly by the borrower to the finance company. It is also referred to as finance paper.

discounted loan A loan in which the calculated interest payment is subtracted, or discounted, in advance. Because this lowers the amount of available funds, the effective interest rate is increased.

discount rate The rate at which future sums or annuities are discounted back to the present.

disinflation A leveling off or slowdown of price increases.

dividend payment date The day on which a stockholder of record will receive his or her dividend.

dividend payout The percentage of dividends to earnings after taxes. It can be computed by dividing dividends per share by earnings per share.

dividend reinvestment plans Plans that provide the investor with an opportunity to buy additional shares of stock with the cash dividends paid by the company.

dividend valuation model A model for determining the value of a share of stock by taking the present value of an expected stream of future dividends.

dividend yield Dividends per share divided by market price per share. Dividend yield indicates the percentage return that a stockholder will receive on dividends alone.

dual trading Exists when one security, such as General Motors common stock, is traded on more than one stock exchange. This practice is quite common between NYSE-listed companies and regional exchanges.

Dun & Bradstreet Information Services (DBIS) A division of Dun & Bradstreet. DBIS is an information company that publishes many different reports that help businesses make credit decisions. Its publications include the reference books *Business Information Report, Financial Stress Report, Payment Analysis Report, Small Business Credit Scoring Report, Commercial Credit Scoring Report, Supplier Evaluation* and various *Industry Credit Score Reports.*

Du Pont system of analysis An analysis of profitability that breaks down return on assets between the profit margin and asset turnover. The second, or modified, version shows how return on assets is translated into return on equity through the amount of debt that the firm has. Actually return on assets is divided by (1 − Debt/Assets) to arrive at return on equity.

Dutch auction preferred stock A preferred stock security that matures every seven weeks and is sold (reauctioned) at a subsequent bidding. The concept of Dutch auction means the stock is issued to the bidder willing to accept the lowest yield and then to the next lowest bidder and so on until all the preferred stock is sold.

E

earnings per share The earnings available to common stockholders divided by the number of common stock shares outstanding.

economic ordering quantity (EOQ) The most efficient ordering quantity for the firm. The EOQ will allow the firm to minimize the total ordering and carrying costs associated with inventory.

efficient frontier A line drawn through the optimum point selections in a risk-return trade-off diagram.

efficient market hypothesis Hypothesis that suggests markets adjust very quickly to new information and that it is very difficult for investors to select portfolios of securities that outperform the market. The efficient market hypothesis may be stated in many different forms, as indicated in Chapter 14.

elective expensing Writing off an asset in the year of purchase for tax purposes rather than depreciating it over the life of the asset. The maximum annual deduction is $100,000. This procedure is primarily beneficial to small businesses because its availability is phased out when asset purchases become large.

electronic communications networks (ECNU) Electronic trading systems that automatically match buy and sell orders at specific prices.

electronic funds transfer A system in which funds are moved between computer terminals without the use of written checks.

EMU (European Monetary Union) A group of 12 European countries that share a common currency (euro) and common interest rate.

euro The common currency shared by the 12 members of the European Monetary Union.

Eurobonds Bonds payable or denominated in the borrower's currency, but sold outside the country of the borrower, usually by an international syndicate.

Eurodollar certificate of deposit A certificate of deposit based on U.S. dollars held on deposit by foreign banks.

Eurodollar loans Loans made by foreign banks denominated in U.S. dollars.

Eurodollars U.S. dollars held on deposit by foreign banks and loaned out by those banks to anyone seeking dollars.

exchange rate The relationship between the value of two or more currencies. For example, the exchange rate between U.S. dollars and French francs is stated as dollars per francs or francs per dollar.

ex-dividend date Two business days before the holder-of-record date. On the ex-dividend date the purchase of the stock no longer carries with it the right to receive the dividend previously declared.

exercise price The price at which a warrant (or other similar security) allows the investor to purchase common stock.

Eximbank (Export-Import Bank) An agency of the U.S. government that facilitates the financing of U.S. exports through its miscellaneous programs. In its direct loan program, the Eximbank lends money to foreign purchasers of U.S. products, such as aircraft, electrical equipment, heavy machinery, computers, and the like. The Eximbank also purchases eligible medium-term obligations of foreign buyers of U.S. goods at a discount from face value. In this discount program, private banks and other lenders are able to rediscount (sell at a lower price) promissory notes and drafts acquired from foreign customers of U.S. firms.

expectations hypothesis The hypothesis maintains that the yields on long-term securities are a function of short-term rates. The result of the hypothesis is that, when long-term rates are much higher than short-term rates, the market is saying that it expects short-term rates to rise. Conversely, when long-term rates are lower than short-term rates, the market is expecting short-term rates to fall.

expected value A representative value from a probability distribution arrived at by multiplying each outcome by the associated probability and summing up the values.

expropriate The action of a country in taking away or modifying the property rights of a corporation or individual.

ex-rights The situation in which the purchase of common stock during a rights offering no longer includes rights to purchase additional shares of common stock.

extension An out-of-court settlement in which creditors agree to allow the firm more time to meet its financial obligations. A new repayment schedule will be developed, subject to the acceptance of creditors.

external corporate funds Corporate financing raised through sources outside of the firm. Bonds, common stock, and preferred stock fall in this category.

external reorganization A reorganization under the formal bankruptcy laws, in which a merger partner is found for the distressed firm. Ideally, the distressed firm should be merged with a strong firm in its own industry, although this is not always possible.

F

factoring Selling accounts receivable to a finance company or a bank.

federal deficit Government expenditures are greater than government tax revenues, and the government must borrow to balance revenues and expenditures. These deficits act as an economic stimulus.

federally sponsored credit agencies Federal agencies, such as the Federal Home Loan Banks and the Federal Land Bank, that issue securities.

Federal National Mortgage Association (Fannie Mae) A former government agency that provides a secondary market in mortgages. It is now private.

Federal Reserve discount rate The rate of interest that the Fed charges on loans to the banking system. A monetary tool for management of the money supply.

federal surplus This occurs when government tax receipts are greater than government expenditures. Surpluses may have a dampening effect on the economy.

field warehousing An inventory financing arrangement in which collateralized inventory is stored on the premises of the borrower but is controlled by an independent warehousing company.

FIFO A system of writing off inventory into cost of goods sold, in which the items purchased first are written off first. Referred to as first-in, first-out.

finance paper A form of commercial paper that is sold directly to the lender by the finance company. It is also referred to as direct paper.

Financial Accounting Standards Board A privately supported rule-making body for the accounting profession.

financial capital Common stock, preferred stock, bonds, and retained earnings. Financial capital appears on the corporate balance sheet under long-term liabilities and equity.

financial disclosure Presentation of financial information to the investment community.

financial futures market A market that allows the trading of financial instruments related to a future point in time. A purchase or sale occurs in the present, with a reversal necessitated in the future to close out the position. If a purchase (sale) occurs initially, then a sale (purchase) will be necessary in the future. The market provides for futures contracts in Treasury bonds, Treasury bills, certificates of deposits, GNMA certificates, and many other instruments. Financial futures contracts may be executed on the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Futures Exchange, and other exchanges.

financial intermediary A financial institution, such as a bank or a life insurance company, that directs other people's money into such investments as government and corporate securities.

financial lease A long-term, noncancelable lease. The financial lease has all the characteristics of long-term debt.

financial leverage A measure of the amount of debt used in the capital structure of the firm.

financial markets The place of interaction for people, corporations, and institutions that either need money or have money to lend or invest.

financial risk The risk related to the inability of the firm to meet its debt obligations as they come due.

financial sweetener Usually refers to equity options, such as warrants or conversion privileges, attached to a debt security. The sweetener lowers the interest cost to the corporation.

fiscal policy The tax policies of the federal government and the spending associated with its tax revenues.

five c's of credit These are used by bankers and others to determine whether a loan will be repaid on time. The five c's are character, capital, capacity, conditions, and collateral.

fixed costs Costs that remain relatively constant regardless of the volume of operations. Examples are rent, depreciation, property taxes, and executive salaries.

float The difference between the corporation's recorded cash balance on its books and the amount credited to the corporation by the bank.

floating rate bond A bond in which the interest payment changes with market conditions.

floating rate preferred stock The quarterly dividend on the preferred stock changes with market rates. The market price is considerably less volatile than it is with regular preferred stock.

floor value Usually equal to the pure bond value. A convertible bond will not sell at less than its floor value even when its conversion value is below the pure bond value.

flotation cost The distribution cost of selling securities to the public. The cost includes the underwriter's spread and any associated fees.

forced conversion Occurs when a company calls a convertible security that has a conversion value greater than the call price. Investors will take the higher of the two values and convert the security to common stock, rather than take a lower cash call price.

Foreign Credit Insurance Association (FCIA) An agency established by a group of 60 U.S. insurance companies. It sells credit export insurance to interested exporters. The FCIA promises to pay for the exported merchandise if the foreign importer defaults on payment.

foreign exchange risk A form of risk that refers to the possibility of experiencing a drop in revenue or an increase in cost in an international transaction due to a change in foreign exchange rates. Importers, exporters, investors, and multinational firms alike are exposed to this risk.

foreign trade deficit A deficit that occurs because Americans buy (import) more foreign goods than American companies sell (export) to foreigners.

forward rate A rate that reflects the future value of a currency based on expectations. Forward rates may be greater than the current spot rate (premium) or less than the current spot rate (discount).

founders' shares Stock owned by the original founders of a company. It often carries special voting rights that allow the founders to maintain voting privileges in excess of their proportionate ownership.

free cash flow Cash flow from operating activities, minus expenditures required to maintain the productive capacity of the firm, minus dividend payouts.

fronting loan A parent company's loan to a foreign subsidiary is channeled through a financial intermediary, usually a large international bank. The bank fronts for the parent in extending the loan to the foreign affiliate.

fully diluted earnings per share Equals adjusted earnings after taxes divided by shares outstanding, plus common stock equivalents, plus all convertible securities.

futures contract A contract to buy or sell a commodity at some specified price in the future.

future value The value that a current amount grows to at a given interest rate over a given time period.

future value of an annuity The sum of the future value of a series of consecutive equal payments.

G

going private The process by which all publicly owned shares of common stock are repurchased or retired, thereby eliminating listing fees, annual reports, and other expenses involved with publicly owned companies.

golden parachute Highly attractive termination payments made to current management in the event of a takeover of the company.

goodwill An intangible asset that reflects value above that generally recognized in the tangible assets of the firm.

H

hedging To engage in a transaction that partially or fully reduces a prior risk exposure by taking a position that is the opposite of your initial position. As an example, you own some copper now but also engage in a contract to sell copper in the future at a set price.

historical cost accounting The traditional method of accounting, in which financial statements are developed based on original cost.

holder-of-record date Stockholders owning the stock on the holder-of-record date are entitled to receive a dividend. In order to be listed as an owner on the corporate books, the investor must have bought the stock before it went ex-dividend.

horizontal integration The acquisition of a competitor.

humped yield curve A yield curve in which intermediate rates are higher than both short- and long-term rates.

hurdle rate The minimum acceptable rate of return in a capital budgeting decision.

I

income statement A financial statement that measures the profitability of the firm over a time period. All expenses are subtracted from sales to arrive at net income.

incremental depreciation The depreciation on a new asset minus the depreciation on an old asset.

Incremental depreciation is multiplied times the tax rate to determine its tax shield benefit.

indenture A legal contract between the borrower and the lender that covers every detail regarding a bond issue.

indexing An adjustment for inflation incorporated into the operation of an economy. Indexing may be used to revalue assets on the balance sheet and to automatically adjust wages, tax deductions, interest payments, and a wide variety of other categories to account for inflation.

inflation The phenomenon of prices increasing with the passage of time.

inflation premium A premium to compensate the investor for the eroding effect of inflation on the value of the dollar.

information content of dividends This theory of dividends assumes that dividends provide information about the financial health and economic expectations of the company. If this is true, corporations must actively manage their dividends to provide the market with information.

insider trading This occurs when someone has information that is not available to the public and then uses this information to profit from trading in a company's common stock.

installment loan A borrowing arrangement in which a series of equal payments are used to pay off a loan.

institutional investors Large investors such as pension funds or mutual funds.

interest factor The tabular value to insert into the various present value and future value formulas. It is based on the number of periods (n) and the interest rate (i).

interest rate parity theory A theory based on the interplay between interest rate differentials and exchange rates. If one country has a higher interest rate than another country after adjustments for inflation, interest rates and foreign exchange rates will adjust until the foreign exchange rates and money market rates reach equilibrium (are properly balanced between the two countries).

Intermarket Trading System (ITS) An electronic communications system that links nine markets—NYSE, AMEX, Boston, Chicago, Cincinnati, Pacific, and Philadelphia stock exchanges, the Chicago Board Options Exchange, and the Nasdaq.

internally generated funds Funds generated through the operations of the firm. The principal sources are retained earnings and cash flow added back from depreciation and other noncash deductions.

internal rate of return (IRR) A discounted cash flow method for evaluating capital budgeting projects. The IRR is a discount rate that makes the present value of the cash inflows equal to the present value of the cash outflows.

internal reorganization A reorganization under the formal bankruptcy laws. New management may be brought in and a redesign of the capital structure may be implemented.

international diversification Achieving diversification through many different foreign investments that are influenced by a variety of factors.

international electronic funds transfer The movement of funds across international boundaries. It is mainly carried out through SWIFT (Society for Worldwide Interbank Financial Telecommunications).

International Finance Corporation (IFC) An affiliate of the World Bank established with the sole purpose of providing partial seed capital for private ventures around the world. Whenever a multinational company has difficulty raising equity capital due to lack of adequate private risk capital, the firm may explore the possibility of selling equity or debt (totaling up to 25 percent of total capital) to the International Finance Corporation.

intrinsic value As applied to a warrant, this represents the market value of common stock minus the exercise price. The difference is then multiplied by the number of shares each warrant entitles the holder to purchase.

inventory profits Profits generated as a result of an inflationary economy, in which old inventory is sold at large profits because of increasing prices. This is particularly prevalent under FIFO accounting.

inverted yield curve A downward-sloping yield curve. Short-term rates are higher than long-term rates.

investment banker A financial organization that specializes in selling primary offerings of securities. Investment bankers can also perform other financial functions, such as advising clients, negotiating mergers and takeovers, and selling secondary offerings.

J

just-in-time inventory management (JIT) A system of inventory management that stresses taking possession of inventory just before the time it is needed for production or sale. It greatly reduces the cost of carrying inventory.

L

lease A contractual arrangement between the owner of equipment (lessor) and the user of equipment (lessee) that calls for the lessee to pay the lessor an established lease payment. There are two kinds of leases: financial leases and operating leases.

letter of credit A credit letter normally issued by the importer's bank, in which the bank promises to pay out the money for the merchandise when delivered.

level production Equal monthly production used to smooth out production schedules and employ manpower and equipment more efficiently and at a lower cost.

leverage The use of fixed-charge items with the intent of magnifying the potential returns to the firm.

leveraged buyout Existing management or an outsider makes an offer to "go private" by retiring all the shares of the company. The buying group borrows the necessary money, using the assets of the acquired firm as collateral. The buying group then repurchases all the shares and expects to retire the debt over time with the cash flow from operations or the sale of corporate assets. The firm may ultimately go public again.

LIBOR (See London Interbank Offered Rate.)

life cycle A curve illustrating the growth phases of a firm. The dividend policy most likely to be employed during each phase is often illustrated.

LIFO A system of writing off inventory into cost of goods sold in which the items purchased last are written off first. Referred to as last-in, first-out.

limited partnership A special form of partnership to limit liability for most of the partners. Under this arrangement, one or more partners are designated as general partners and have unlimited liability for the debts of the firm, while the other partners are designated as limited partners and are only liable for their initial contribution.

liquidation A procedure that may be carried out under the formal bankruptcy laws when an internal or external reorganization does not appear to be feasible, and it appears that the assets are worth more in liquidation than through a reorganization. Priority of claims becomes extremely important in a liquidation because it is unlikely that all parties will be fully satisfied in their demands.

liquidity The relative convertibility of short-term assets to cash. Thus, marketable securities are highly liquid assets, while inventory may not be.

liquidity premium theory This theory indicates that long-term rates should be higher than short-term rates. The premium of long-term rates over short-term rates exists because short-term securities have greater liquidity, and, therefore, higher rates have to be offered to potential long-term bond buyers to entice them to hold these less liquid and more price sensitive securities.

liquidity ratios A group of ratios that allows one to measure the firm's ability to pay off short-term obligations as they come due. Primary attention is directed to the current ratio and the quick ratio.

listing requirements Financial standards that corporations must meet before their common stock can be traded on a stock exchange. Listing requirements are not standard, but are set by each exchange. The requirements for the NYSE are the most stringent.

lockbox system A procedure used to expedite cash inflows to a business. Customers are requested to forward their checks to a post office box in their geographic region, and a local bank picks up the checks and processes them for rapid collection. Funds are then wired to the corporate home office for immediate use.

London Interbank Offered Rate (LIBOR) An interbank rate applicable for large deposits in the London market. It is a benchmark rate, just like the prime interest rate in the United States. Interest rates on Eurodollar loans are determined by adding premiums to this basic rate. Most often, LIBOR is lower than the U.S. prime rate.

M

majority voting All directors must be elected by a vote of more than 50 percent. Minority shareholders are unable to achieve any representation on the board of directors.

managing investment banker An investment banker who is responsible for the pricing, prospectus development, and legal work involved in the sale of a new issue of securities.

marginal corporate tax rate The rate that applies to each new dollar of taxable income. For a corporation, the maximum rate is 35 percent. The marginal rate is lower for smaller corporations.

marginal cost of capital The cost of the last dollar of funds raised. It is assumed that each dollar is financed in proportion to the firm's optimum capital structure.

marginal principle of retained earnings The corporation must be able to earn a higher return on its retained earnings than a stockholder would receive after paying taxes on the distributed dividends.

margin requirement A rule that specifies the amount of cash or equity that must be deposited with a brokerage firm or bank, with the balance of funds eligible for borrowing. Margin is set by the Board of Governors of the Federal Reserve Board.

market efficiency Markets are considered to be efficient when (1) prices adjust rapidly to new information; (2) there is a continuous market, in which each successive trade is made at a price close to the previous price (the faster the price responds to new information and the smaller the differences in price changes, the more efficient the market); and (3) the market can absorb large dollar amounts of securities without destabilizing the prices.

market risk premium A premium over and above the risk-free rate. It is represented by the difference between the market return (K_m) and the risk-free rate (R_f), and it may be multiplied by the beta coefficient to determine the additional risk-adjusted return on a security.

market segmentation theory A theory that Treasury securities are divided into market segments by various financial institutions investing in the market. The changing needs, desires, and strategies of these investors tend to strongly influence the nature and relationship of short-term and long-term interest rates.

market stabilization Intervention in the secondary markets by an investment banker to stabilize the price of a new security offering during the offering period. The purpose of market stabilization is to provide an orderly market for the distribution of the new issue.

market value maximization The concept of maximizing the wealth of shareholders. This calls for a recognition not only of earnings per share but also how they will be valued in the marketplace.

maturity date The date on which the bond is retired and the principal (par value) is repaid to the lender.

merger The combination of two or more companies, in which the resulting firms maintain the identity of the acquiring company.

merger premium The part of a buyout or exchange offer that represents a value over and above the market value of the acquired firm.

modified accelerated cost recovery system (MACRS) A system that specifies the allowable depreciation recovery period for different types of assets. The normal recovery period is generally shorter than the physical life of the asset.

modified internal rate of return A method of evaluation combining the reinvestment rate assumption of the net present value method (cost of capital) with the internal rate of return method.

monetary policy Management by the Federal Reserve Board of the money supply and the resultant interest rates.

money market accounts Accounts at banks, savings and loans, and credit unions in which the depositor receives competitive money market rates on a typical minimum deposit of $1,000. These accounts may generally have three deposits and three withdrawals per month and are not meant to be transaction accounts, but a place to keep minimum and excess cash balances. These accounts are insured by various appropriate governmental agencies up to $100,000.

money market fund A fund in which investors may purchase shares for as little as $500 or $1,000. The fund then reinvests the proceeds in high-yielding $100,000 bank CDs, $25,000–$100,000 commercial paper, and other large-denomination, high-yielding securities. Investors receive their pro rata portion of the interest proceeds daily as a credit to their shares.

money markets Competitive markets for securities with maturities of one year or less. The best examples of money market instruments would be Treasury bills, commercial paper, and negotiable certificates of deposit.

mortgage agreement A loan that requires real property (plant and equipment) as collateral.

multinational corporation A firm doing business across its national borders is considered a multinational enterprise. Some definitions require a minimum percentage (often 30 percent or more) of a firm's business activities to be carried on outside its national borders.

municipal securities Securities issued by state and local government units. The income from these securities is exempt from federal income taxes.

mutually exclusive The selection of one choice precludes the selection of any other competitive choice. For example, several machines can do an identical job in capital budgeting. If one machine is selected, the other machines will not be used.

N

Nasdaq National Market The segment of the over-the-counter market with the largest companies.

Nasdaq Small-Cap Market The list includes companies centered in one city or state with little national ownership, or small development companies with stock priced as low as 25 cents per share, or companies that are closely held by the founders with very few shares available for trading.

National Association of Security Dealers (NASD) An industry association that supervises the over-the-counter market.

National Market List The list of the best-known and most widely traded securities in the over-the-counter market.

net present value (NPV) The NPV equals the present value of the cash inflows minus the present value of the cash outflows with the cost of capital used as a discount rate. This method is used to evaluate capital budgeting projects. If the NPV is positive, a project should be accepted.

net present value profile A graphic presentation of the potential net present values of a project at different discount rates. It is very helpful in comparing the characteristics of two or more investments.

net trade credit A measure of the relationship between the firm's accounts receivable and accounts payable. If accounts receivable exceed accounts payable, the firm is a net provider of trade credit; otherwise, it is a net user.

net worth, or book value Stockholders' equity minus preferred stock ownership. Basically, net worth is the common stockholders' interest as represented by common stock par value, capital paid in excess of par, and retained earnings. If you take all the assets of the firm and subtract its liabilities and preferred stock, you arrive at net worth.

New York Stock Exchange (NYSE) The largest organized security exchange in the United States. It also has the most stringent listing requirements.

nominal GDP GDP (gross domestic product) in current dollars without any adjustments for inflation.

nominal yield A return equal to the coupon rate on a bond.

nonfinancial corporation A firm not in the banking or financial services industry. The term would primarily apply to manufacturing, wholesaling, and retail firms.

nonlinear break-even analysis Break-even analysis based on the assumption that cost and revenue relationships to quantity may vary at different levels of operation. Most of our analyses are based on *linear* break-even analysis.

normal yield curve An upward-sloping yield curve. Long-term interest rates are higher than short-term rates.

O

open-market operations The purchase and sale of government securities in the open market by the Federal Reserve Board for its own account. The most common method for managing the money supply.

operating lease A short-term, nonbinding obligation that is easily cancelable.

operating leverage A reflection of the extent to which fixed assets and fixed costs are utilized in the business firm.

optimum capital structure A capital structure that has the best possible mix of debt, preferred stock, and common equity. The optimum mix should provide the lowest possible cost of capital to the firm.

options These give the owner the right but not the obligation to buy or sell an underlying security at a set price for a given time period.

Overseas Private Investment Corporation (OPIC) A government agency that sells insurance policies to qualified firms. This agency insures against losses due to inconvertibility into dollars of amounts invested in a foreign country. Policies are also available from OPIC to insure against expropriation and against losses due to war or revolution.

over-the-counter markets Markets for securities (both bonds and stock) in which market makers, or dealers, transact purchases and sales of securities by trading from their own inventory of securities.

P

parallel loan A U.S. firm that wishes to lend funds to a foreign affiliate (such as a Dutch affiliate) locates a foreign parent firm (such as a Dutch parent firm) that wishes to loan money to a U.S. affiliate. Avoiding the foreign exchange markets entirely, the U.S. parent lends dollars to the Dutch affiliate in the United States, while the Dutch parent lends guilders to the American affiliate in the Netherlands. At maturity, the two loans would each be repaid to the original lender. Notice that neither loan carries any foreign exchange risk in this arrangement.

par value Sometimes referred to as the face value or the principal value of the bond. Most bond issues have a par value of $1,000 per bond. Common and preferred stock may also have an assigned par values.

participating preferred stock A small number of preferred stock issues are participating with regard to corporate earnings. For such issues, once the common stock dividend equals the preferred stock dividend, the two classes of securities may share equally in additional dividend payments.

partnership A form of ownership in which two or more partners are involved. Like the sole proprietorship, a partnership arrangement carries unlimited liability for the owners. However, there is only single taxation for the partners, an advantage over the corporate form of ownership.

passbook savings account A savings account in which a passbook is used to record transactions. It is normally the lowest yielding investment at a financial institution.

payback A value that indicates the time period required to recoup an initial investment. The payback does not include the time-value-of-money concept.

percent-of-sales method A method of determining future financial needs that is an alternative to the development of pro forma financial statements. We first determine the percentage relationship of various asset and liability accounts to sales, and then we show how that relationship changes as our volume of sales changes.

permanent current assets Current assets that will not be reduced or converted to cash within the normal operating cycle of the firm. Though from a strict accounting standpoint the assets should be removed from the current assets category, they generally are not.

perpetuity An investment without a maturity date.

planning horizon The length of time it takes to conceive, develop, and complete a project and to recover the cost of the project on a discounted cash flow basis.

pledging accounts receivables Using accounts receivable as collateral for a loan. The firm usually may borrow 60 to 80 percent of the value of acceptable collateral.

point-of-sales terminals Computer terminals in retail stores that either allow digital input or use optical scanners. The terminals may be used for inventory control or other purposes.

poison pill A strategy that makes a firm unattractive as a potential takeover candidate. For example, when a potential unwanted buyer accumulates a given percentage of a firm's common stock, such as 25 percent, the other shareholders receive rights to purchase additional shares at very low prices. This makes the firm more difficult to acquire. Poison pills may take many different forms.

pooling of interests A method of financial recording for mergers, in which the financial statements of the firms are combined, subject to minor adjustments, and goodwill is *not* created. The method is being phased out by the Financial Accounting Standards Board (FASB).

portfolio effect The impact of a given investment on the overall risk-return composition of the firm. A firm must consider not only the individual investment characteristics of a project but also how the project relates to the entire portfolio of undertakings.

precautionary balances Cash balances held for emergency purposes. Precautionary cash balances are more likely to be important in seasonal or cyclical industries where cash inflows are more uncertain.

preemptive right The right of current common stockholders to maintain their ownership percentage on new issues of common stock.

preferred stock A hybrid security combining some of the characteristics of common stock and debt. The dividends paid are not tax-deductible expenses of the corporation, as is true of the interest paid on debt.

present value The current or discounted value of a future sum or annuity. The value is discounted back at a given interest rate for a specified time period.

present value of an annuity The sum of the present value of a series of consecutive equal payments.

price-earnings ratio The multiplier applied to earnings per share to determine current value. The P/E ratio is influenced by the earnings and sales growth of the firm, the risk or volatility of its performance, the debt-equity structure, and other factors.

primary market The market for the raising of new funds as opposed to the trading of securities already in existence.

prime rate The rate that a bank charges its most creditworthy customers.

private placement The sale of securities directly to a financial institution by a corporation. This eliminates the middleman and reduces the cost of issue to the corporation.

privatization A process in which investment bankers take companies that were previously owned by the government to the public markets.

profitability ratios A group of ratios that indicates the return on sales, total assets, and invested capital. Specifically, we compute the profit margin (net income to sales), return on assets, and return on equity.

pro forma balance sheet A projection of future asset, liability, and stockholders' equity levels. Notes payable or cash is used as a plug or balancing figure for the statement.

pro forma financial statements A series of projected financial statements. Of major importance are the pro forma income statement, the pro forma balance sheet, and the cash budget.

pro forma income statement A projection of anticipated sales, expenses, and income.

program trading Computer-based trigger points in the market are established for unusually big orders to buy or sell securities by institutional investors.

prospectus A document that includes the important information that has been filed with the Securities and Exchange Commission through the registration statement. It contains the list of officers and directors, financial reports, potential uses of funds, and the like.

proxy This represents the assignment of the voting right to management or a group of outsiders.

public finance markets Markets in which national, state, and local governments raise money for highways, education, welfare, and other public activities.

public placement The sale of securities to the public through the investment banker–underwriter process. Public placements must be registered with the Securities and Exchange Commission.

public warehousing An inventory financing arrangement in which inventory, used as collateral, is stored with and controlled by an independent warehousing company.

purchase of assets A method of financial recording for mergers, in which the difference between the purchase price and the adjusted book value is recognized as goodwill. Under new rulings by the FASB, goodwill does not need to be written off under normal circumstances.

purchasing power parity theory A theory based on the interplay between inflation and exchange rates. A parity between the purchasing powers of two countries establishes the rate of exchange between the two currencies. Currency exchange rates therefore tend to vary inversely with their respective purchasing powers in order to provide the same or similar purchasing power.

pure bond value The value of the convertible bond if its present value is computed at a discount rate equal to interest rates on straight bonds of equal risk, without conversion privileges.

put option An option to sell securities at a set price over a specified period of time.

R

real capital Long-term productive assets (plant and equipment).

real GDP (gross domestic product) GDP stated in current dollars adjusted for inflation.

real rate of return The rate of return that an investor demands for giving up the current use of his or her funds on a noninflation-adjusted basis.

It is payment for forgoing current consumption. Historically, the real rate of return demanded by investors has been of the magnitude of 2 to 3 percent.

refunding The process of retiring an old bond issue before maturity and replacing it with a new issue. Refunding will occur when interest rates have fallen and new bonds may be sold at lower interest rates.

regional stock exchanges Organized exchanges outside of New York that list securities.

reinvestment assumption An assumption made concerning the rate of return that can be earned on the cash flows generated by capital budgeting projects. The NPV method assumes the rate of reinvestment to be the cost of capital, while the IRR method assumes the rate to be the actual internal rate of return.

repatriation of earnings Earnings returned to the multinational parent company in the form of dividends.

replacement cost The cost of replacing the existing asset base at current prices as opposed to original cost.

replacement cost accounting Financial statements based on the present cost of replacing assets.

replacement decision The capital budgeting decision on whether to replace an old asset with a new one. An advance in technology is often involved.

required rate of return That rate of return that investors demand from an investment to compensate them for the amount of risk involved.

reserve requirements The amount of funds that commercial banks must hold in reserve for each dollar of deposits. Reserve requirements are set by the Federal Reserve Board and are different for savings and checking accounts. Low reserve requirements are stimulating; high reserve requirements are restrictive.

residual claim to income The basic claim that common stockholders have to income that is not paid out to creditors or preferred stockholders. This is true regardless of whether these residual funds are paid out in dividends or retained in the corporation.

residual theory of dividends A theory of dividend payout stating that a corporation will retain as much of its earnings as it may profitably invest. If any income is left after investments, the firm will pay dividends. This theory assumes that dividends are a passive decision variable.

restructuring Process that can take many forms in a corporation, such as changes in the capital structure (liability and equity on the balance sheet). It can also result in the selling of low-profit-margin divisions with the proceeds reinvested in better investment opportunities. Sometimes restructuring results in the removal of the current management team or large reductions in the workforce. Restructuring has also included mergers and acquisitions.

reverse stock split A firm exchanging with stockholders fewer shares for existing shares with the intent of increasing the stock price.

rights offering A sale of new common stock through a preemptive rights offering. Usually one right will be issued for every share held. A certain number of rights may be used to buy shares of common stock from the company at a set price that is lower than the market price.

rights-on The situation in which the purchase of a share of common stock includes a right attached to the stock.

risk A measure of uncertainty about the outcome from a given event. The greater the variability of possible outcomes, on both the high side and the low side, the greater the risk.

risk-adjusted discount rate A discount rate used in the capital budgeting process that has been adjusted upward or downward from the basic cost of capital to reflect the risk dimension of a given project.

risk-averse An aversion or dislike for risk. In order to induce most people to take larger risks, there must be increased potential for return.

risk-free rate of return Rate of return on an asset that carries no risk. U.S. Treasury bills are often used to represent this measure, although longer-term government securities have also proved appropriate in some studies.

risk premium A premium associated with the special risks of an investment. Of primary interest are two types of risk, business risk and financial risk. Business risk relates to the inability of the firm to maintain its competitive position and sustain stability and growth in earnings. Financial risk relates to the inability of the firm to meet its debt obligations as they come due. The risk premium will also differ (be greater or less) for different types of investments (bonds, stocks, and the like).

S

safety stock of inventory Inventory that is held in addition to regular needs to protect against being out of an item.

Sarbanes-Oxley Act of 2002 An act that was intended to restore confidence in the financial markets by demanding accuracy in financial reporting.

Saturday night special A merger tender offer that is made just before the market closes for the weekend and takes the target company's officers by surprise.

screen-based market There is no physical location, but trading is based on computers and other communication mediums.

secondary market The market for securities that have already been issued. It is a market in which investors trade back and forth with each other.

secondary offering The sale of a large block of stock in a publicly traded company, usually by estates, foundations, or large individual stockholders. Secondary offerings must be registered with the SEC and will usually be distributed by investment bankers.

secondary trading The buying and selling of publicly owned securities in secondary markets, such as the New York Stock Exchange and the over-the-counter markets.

secured debt A general category of debt that indicates the loan was obtained by pledging assets as collateral. Secured debt has many forms and usually offers some protective features to a given class of bondholders.

Securities Act of 1933 An act that is sometimes referred to as the truth in securities act, because it requires detailed financial disclosures before securities may be sold to the public.

Securities Acts Amendments of 1975 The major feature of this act was to mandate a national securities market.

Securities and Exchange Commission (SEC) The primary regulatory body for security offerings in the United States.

Securities Exchange Act of 1934 Legislation that established the Securities and Exchange Commission (SEC) to supervise and regulate the securities markets.

securitization of assets The issuance of a security that is specifically backed by the pledge of an asset.

security market line A line or equation that depicts the risk-related return of a security based on a risk-free rate plus a market premium related to the beta coefficient of the security.

self-liquidating assets Assets that are converted to cash within the normal operating cycle of the firm. An example is the purchase and sale of seasonal inventory.

self-liquidating loan A loan in which the use of funds will ensure a built-in or automatic repayment scheme.

semivariable costs Costs that are partially fixed but still change somewhat as volume changes. Examples are utilities and "repairs and maintenance."

serial payment Bonds with serial payment provisions are paid off in installments over the life of the issue. Each bond has its own predetermined date of maturity and receives interest only to that point.

shareholder wealth maximization Maximizing the wealth of the firm's shareholders through achieving the highest possible value for the firm in the marketplace. It is the overriding objective of the firm and should influence all decisions.

shelf registration A process that permits large companies to file one comprehensive registration statement (under SEC Rule 415) that outlines the firm's financing plans for up to the next two years. Then, when market conditions appear to be appropriate, the firm can issue the securities without further SEC approval.

simulation A method of dealing with uncertainty, in which future outcomes are anticipated. The model may use random variables for inputs. By programming the computer to randomly select inputs from probability distributions, the outcomes generated by a simulation are distributed about a mean, and, instead of generating one return or net present value, a range of outcomes with standard deviations is provided.

sinking fund A method for retiring bonds in an orderly process over the life of a bond. Each year or semiannually, a corporation sets aside a sum of money equal to a certain percentage of the total issue. These funds are then used by a trustee to purchase the bonds in the open market and retire them. This method will prevent the corporation from being forced to raise a large amount of capital at maturity to retire the total bond issue.

sole proprietorship A form of organization that represents single-person ownership and offers the advantages of simplicity of decision making and low organizational and operating costs.

speculative premium The market price of the warrant minus the warrant's intrinsic value is an example of a speculative premium.

spontaneous sources of funds Funds arising through the normal course of business, such as accounts payable generated from the purchase of goods for resale.

spot rate The rate at which the currency is traded for immediate delivery. It is the existing cash price.

standard deviation A measure of the spread or dispersion of a series of numbers around the expected value. The standard deviation tells us how well the expected value represents a series of values.

statement of cash flows Formally established by the Financial Accounting Standards Board in 1987, the purpose of the statement of cash flows is to emphasize the critical nature of cash flow to the operations of the firm. The statement translates accrual-based net income into actual cash dollars.

step-up in the conversion price A feature that is sometimes written into the contract that allows the conversion ratio to decline in steps over time. This feature encourages early conversion when the conversion value is greater than the call price.

stock dividend A dividend paid in stock, rather than cash. A book transfer equal to the market value of the stock dividend is made from retained earnings to the capital stock and paid-in-capital accounts. The stock dividend may be symbolic of corporate growth, but it does not increase the total value of the stockholders' wealth.

stock split A division of shares by a ratio set by the board of directors—two for one, three for one, three for two, and so on. Stock splits usually indicate the company's stock has risen in price to a level that the directors feel limits the trading appeal of the stock. The par value is divided by the ratio set, and the new shares are issued to the current stockholders of record to increase their shares to the stated level. For example, a two-for-one split would increase holdings from one share to two shares.

stockholders' equity The total ownership position of preferred and common stockholders.

stockholder wealth maximization The primary goal of financial managers. They maximize the wealth of the firm's shareholders through achieving the highest possible value for the firm.

straight-line depreciation A method of depreciation that takes the depreciable cost of an asset and divides it by the asset's useful life to determine the annual depreciation expense. Straight-line depreciation creates uniform depreciation expenses for each of the years in which an asset is depreciated.

Subchapter S corporation A special corporate form of ownership, in which profit is taxed as direct income to the stockholders and thus is only taxed once, as would be true of a partnership. The stockholders still receive all the organizational benefits of a corporation, including limited liability. The Subchapter S designation can apply only to corporations with up to 75 stockholders.

subordinated debenture An unsecured bond, in which payment to the holder will occur only after designated senior debenture holders are satisfied.

supernormal growth Superior growth a firm may achieve during its early years, before leveling off to more normal growth. Supernormal growth is often achieved by firms in emerging industries.

sweep account An account that allows companies to maintain zero balances with all excess cash swept into an interest-earning account.

synergy The recognition that the whole may be equal to more than the sum of the parts. The "2 + 2 = 5" effect.

T

takeover tender offer An unfriendly offer that is not initially negotiated with the management of the target firm. The offer is usually made directly to the stockholders of the target firm.

tax loss carryforward A loss that can be carried forward for a number of years to offset future taxable income and perhaps be utilized by another firm in a merger or an acquisition.

Tax Reform Act of 1986 Tax legislation that eliminated many of the abuses in the tax code and, at the same time, lowered the overall tax rates.

technical insolvency When a firm is unable to pay its bills as they come due.

temporary current assets Current assets that will be reduced or converted to cash within the normal operating cycle of the firm.

term loan An intermediate-length loan, in which credit is generally extended from one to seven years. The loan is usually repaid in monthly or quarterly installments over its life, rather than with one single payment.

terms of exchange The buyout ratio or terms of trade in a merger or an acquisition.

term structure of interest rates The term structure shows the relative level of short-term and long-term interest rates at a point in time.

three-sector economy The economy consists of three sectors—business, government, and households. Typically, households have been major suppliers of funds, while business and government have been users of funds.

tight money A term to indicate time periods in which financing may be difficult to find and interest rates may be quite high by normal standards.

trade credit Credit provided by sellers or suppliers in the normal course of business.

traditional approach to cost of capital Under the traditional approach, the cost of capital initially declines with the increased use of low-cost debt, but it eventually goes up due to the greater risk associated with increasing debt.

transaction exposure Foreign exchange gains and losses resulting from *actual* international transactions. These may be hedged through the foreign exchange market, the money market, or the currency futures market.

transactions balances Cash balances held to pay for planned corporate expenditures such as supplies, payrolls, and taxes, as well as the infrequent acquisitions of long-term fixed assets.

translation exposure The foreign-located assets and liabilities of a multinational corporation, which are denominated in foreign currency units, and are exposed to losses and gains due to changing exchange rates. This is called accounting or translation exposure.

Treasury bills Short-term obligations of the federal government.

Treasury Inflation Protection Securities (TIPS) This security pays interest semiannually that equals a real rate of return specified by the U.S. Treasury plus principal at maturity that is adjusted annually to reflect inflation's impact on purchasing power.

Treasury notes Intermediate-term obligations of the federal government with maturities from 1 to 10 years.

treasury stock Corporate stock that has been reacquired by the corporation.

trend analysis An analysis of performance that is made over a number of years in order to ascertain significant patterns.

trust receipt An instrument acknowledging that the borrower holds the inventory and proceeds for sale in trust for the lender.

two-step buyout An acquisition plan in which the acquiring company attempts to gain control by offering a very high cash price for 51 percent of the shares of the target company. At the same time, the acquiring company announces a second lower price that will be paid, either in cash, stocks, or bonds, at a subsequent point in time.

U

underpricing When new or additional shares of stock are to be sold, investment bankers will generally set the price at slightly below the current market value to ensure a receptive market for the securities.

underwriting The process of selling securities and, at the same time, assuring the seller a specified price. Underwriting is done by investment bankers and represents a form of risk taking.

underwriting spread The difference between the price that a selling corporation receives for an issue of securities and the price at which the issue is sold to the public. The spread is the fee that investment bankers and others receive for selling securities.

underwriting syndicate A group of investment bankers that is formed to share the risk of a security offering and also to facilitate the distribution of the securities.

V

variable costs Costs that move directly with a change in volume. Examples are raw materials, factory labor, and sales commissions.

vertical integration The acquisition of customers or suppliers by the company.

W

warrant An option to buy securities at a set price for a given time period. Warrants commonly have a life of one to five years or longer and a few are perpetual.

weighted average cost of capital The computed cost of capital determined by multiplying the cost of each item in the optimal capital structure by its weighted representation in the overall capital structure and summing up the results.

white knight A firm that management calls on to help it avoid an unwanted takeover offer. It is an invited suitor.

working capital management The financing and management of the current assets of the firm. The financial manager determines the mix between temporary and permanent "current assets" and the nature of the financing arrangement.

Y

yield The interest rate that equates a future value or an annuity to a given present value.

yield curve A curve that shows interest rates at a specific point in time for all securities having equal risk but different maturity dates. Usually, government securities are used to construct such curves. The yield curve is also referred to as the term structure of interest rates.

yield to maturity The required rate of return on a bond issue. It is the discount rate used in present-valuing future interest payments and the principal payment at maturity. The term is used interchangeably with market rate of interest.

Z

zero-coupon rate bond A bond that is initially sold at a deep discount from face value. The return to the investor is the difference between the investor's cost and the face value received at the end of the life of the bond.