

GLOSSARY*

A

Abnormal return Part of return that is not due to systematic influences, e.g., marketwide price movements.

Absolute priority Rule in bankruptcy proceedings whereby senior creditors are required to be paid in full before junior creditors receive any payment.

Accelerated depreciation Any *depreciation* method that produces larger deductions for depreciation in the early years of a project's life.

Accounts payable (payables, trade debt) Money owed to suppliers.

Accounts receivable (receivables, trade credit) Money owed by customers.

Accrued interest Interest that has been earned but not yet paid.

ACH *Automated Clearing House*.

Acid-test ratio *Quick ratio*.

Adjusted present value (APV) *Net present value* of an asset if financed solely by equity plus the *present value* of any financing side effects.

ADR *American depository receipt*.

Adverse selection A situation in which a pricing policy causes only the less desirable customers to do business, e.g., a rise in insurance prices that leads only the worst risks to buy insurance.

Agency theory Theory of the relationship between a principal, e.g., a shareholder, and an agent of the principal, e.g., the company's manager.

Aging schedule Record of the length of time that *accounts receivable* have been outstanding.

All-or-none underwriting An arrangement whereby a security issue is canceled if the *underwriter* is unable to resell the entire issue.

American depository receipt (ADR) A security issued in the United States to represent shares of a foreign company.

American option *Option* that can be exercised any time before the final exercise date (cf. *European option*).

Amex American Stock Exchange.

Amortization (1) Repayment of a loan by installments; (2) allowance for *depreciation*.

Annual percentage rate (APR) Annual interest rate calculated using *simple interest*.

Annuity Investment that produces a level stream of cash flows for a limited number of periods.

Annuity due *Annuity* whose payments occur at the start of each period.

Annuity factor *Present value* of \$1 paid for each of *t* periods.

*Italicized words are listed elsewhere in the glossary.

Anticipation Arrangements whereby customers who pay before the final date may be entitled to deduct a normal rate of interest.

Appraisal rights A right of shareholders in a *merger* to demand the payment of a fair price for their shares, as determined independently.

Appropriation request Formal request for funds for a capital investment project.

APR *Annual percentage rate*.

APT Arbitrage pricing theory.

APV *Adjusted present value*.

Arbitrage Purchase of one security and simultaneous sale of another to give a risk-free profit.

"Arbitrage" or "risk arbitrage" Often used loosely to describe the taking of offsetting positions in related securities, e.g., at the time of a takeover bid.

Articles of incorporation Legal document establishing a corporation and its structure and purpose.

Asian currency units Dollar deposits held in Singapore or other Asian centers.

Asian option *Option* based on the average price of the asset during the life of the option.

Ask price (offer price) Price at which a dealer is willing to sell (cf. *bid price*).

Asset-backed securities Securities issued by a special purpose company that holds a package of low-risk assets whose cash flows are sufficient to service the *bonds*.

Auction-rate preferred A variant of *floating-rate preferred* stock where the dividend is reset every 49 days by auction.

Authorized share capital Maximum number of shares that a company can issue, as specified in the firm's *articles of incorporation*.

Automated Clearing House (ACH) Private electronic system run by banks for high-volume, low-value payments.

Availability float Checks deposited by a company that have not yet been cleared.

Aval Bank guarantee for debt purchased by *forfeiter*.

B

BA *Banker's acceptance*.

Backwardation Condition in which *spot price* of commodity exceeds price of *future* (cf. *contango*).

Balloon payment Large final payment (e.g., when a loan is repaid in installments).

Banker's acceptance (BA) Written demand that has been accepted by a bank to pay a given sum at a future date (cf. *trade acceptance*).

Barrier option *Option* whose existence depends on asset price hitting some specified barrier (cf. *down-and-out option*, *down-and-in option*).

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Basis point (bp) 0.01 percent.

Basis risk Residual risk that results when the two sides of a hedge do not move exactly together.

Bearer security Security for which primary evidence of ownership is possession of the certificate (cf. *registered security*).

Bear market Widespread decline in security prices (cf. *bull market*).

Benchmark maturity Maturity of a newly issued Treasury bond.

Benefit–cost ratio One plus *profitability index*.

Best-efforts underwriting An arrangement whereby *underwriters* do not commit themselves to selling a security issue but promise only to use best efforts.

Beta Measure of *market risk*.

Bid price Price at which a dealer is willing to buy (cf. *ask price*).

Bill of exchange General term for a document demanding payment.

Bill of lading Document establishing ownership of goods in transit.

Blue-chip company Large and creditworthy company.

Blue-sky laws State laws covering the issue and trading of securities.

Boilerplate Standard terms and conditions, e.g., in a debt contract.

Bond Long-term debt.

Bookbuilding The procedure whereby *underwriters* gather nonbinding indications of demand for a new issue.

Book entry System whereby only one global certificate is issued for *bond* and evidence of ownership is receipt showing interest in this certificate.

Book runner The managing *underwriter* for a new issue. The book runner maintains the book of securities sold.

Bought deal Security issue where one or two *underwriters* buy the entire issue.

bp *Basis point*.

Bracket A term signifying the extent of an *underwriter's* commitment in a new issue, e.g., major bracket, minor bracket.

Break-even analysis Analysis of the level of sales at which a project would just break even.

Bridging loan Short-term loan to provide temporary financing until more permanent financing is arranged.

Bull–bear bond *Bond* whose *principal* repayment is linked to the price of another security. The bonds are issued in two *tranches*: In the first the repayment increases with the price of the other security; in the second the repayment decreases with the price of the other security.

Bulldog bond *Foreign bond* issue made in London.

Bullet payment Single final payment, e.g., of a loan (in contrast to payment in installments).

Bull market Widespread rise in security prices (cf. *bear market*).

Buy-back *Repurchase agreement*.

C

Cable The exchange rate between U.S. dollars and sterling.

Call option Option to buy an asset at a specified *exercise price* on or before a specified exercise date (cf. *put option*).

Call premium (1) Difference between the price at which a company can call its *bonds* and their *face value*; (2) price of an *option*.

Call provision Provision that allows an issuer to buy back the *bond* issue at a stated price.

Cap An upper limit on the interest rate on a *floating-rate note*.

Capital budget List of planned investment projects, usually prepared annually.

Capitalization Long-term debt plus *preferred stock* plus *net worth*.

Capital lease *Financial lease*.

Capital market Financial market (particularly the market for long-term securities).

Capital rationing Shortage of funds that forces a company to choose between worthwhile projects.

Capital structure Mix of different securities issued by a firm.

CAPM Capital asset pricing model.

CAR Cumulative *abnormal return*.

CARDs (Certificates for Amortizing Revolving Debt) *Pass-through securities* backed by credit card *receivables*.

CARs (Certificates of Automobile Receivables) *Pass-through securities* backed by automobile *receivables*.

Carve-out Public offering of shares in a subsidiary.

Cascade Rational herding in which each individual deduces that previous decisions by others may have been based on extra information.

Cash and carry Purchase of a security and simultaneous sale of a *future*, with the balance being financed with a loan or *repo*.

Cash budget Forecast of sources and uses of cash.

Cash-deficiency arrangement Arrangement whereby a project's shareholders agree to provide the operating company with sufficient *net working capital*.

CAT bond *Catastrophe bond*.

Catastrophe bond (CAT bond) *Bond* whose payoffs are linked to a measure of catastrophe losses such as insurance claims.

CD *Certificate of deposit*.

Certainty equivalent A certain cash flow that has the same present value as a specified risky cash flow.

Certificate of deposit (CD) A certificate providing evidence of a bank time deposit.

CFTC Commodity Futures Trading Commission.

CFO Chief financial officer.

Chaebol A Korean conglomerate.

CHIPS *Clearing House Interbank Payments System.*

Clean price (flat price) Bond price excluding *accrued interest* (cf. *dirty price*).

Clearing House Interbank Payments System (CHIPS) An international wire transfer system operated by a group of major banks for high-value dollar payments.

Closed-end mortgage Mortgage against which no additional debt may be issued (cf. *open-end mortgage*).

CMOs *Collateralized mortgage obligations.*

Collar An upper and lower limit on the interest rate on a *floating-rate note*.

Collateral Assets that are given as security for a loan.

Collateralized mortgage obligations (CMOs) A variation on the mortgage *pass-through security*, in which the cash flows from a pool of mortgages are repackaged into several *tranches of bonds* with different maturities.

Collateral trust bonds Bonds secured by *common stocks* or other securities that are owned by the borrower.

Collection float Customer-written checks that have not been received, deposited, and added to the company's available balance (cf. *payment float*).

Commercial draft (bill of exchange) Demand for payment.

Commercial paper Unsecured *notes* issued by companies and maturing within nine months.

Commitment fee Fee charged by bank on an unused *line of credit*.

Common stock Security representing ownership of a corporation.

Compensating balance Non-interest-bearing demand deposits to compensate banks for bank loans or services.

Competitive bidding Means by which public utility *holding companies* are required to choose their *underwriter* (cf. *negotiated underwriting*).

Completion bonding Insurance that a construction contract will be successfully completed.

Compound interest Reinvestment of each interest payment on money invested to earn more interest (cf. *simple interest*).

Compound option Option on an *option*.

Concentration banking System whereby customers make payments to a regional collection center. The collection center pays the funds into a regional bank account and surplus money is transferred to the company's principal bank.

Conditional sale Sale in which ownership does not pass to the buyer until payment is completed.

Conglomerate merger Merger between two companies in unrelated businesses (cf. *horizontal merger*, *vertical merger*).

Consol Name of a perpetual *bond* issued by the British government. Sometimes used as a general term for *perpetuity*.

Contango Condition in which *spot price* of a commodity is below that of the *future* (cf. *backwardation*).

Contingent claim Claim whose value depends on the value of another asset.

Contingent project Project that cannot be undertaken unless another project is also undertaken.

Continuous compounding Interest compounded continuously rather than at fixed intervals.

Controller Officer responsible for budgeting, accounting, and auditing in a firm (cf. *treasurer*).

Convenience yield The extra advantage that firms derive from holding the commodity rather than the *future*.

Conversion price *Par value* of a *convertible bond* divided by the number of shares into which it may be exchanged.

Conversion ratio Number of shares for which a *convertible bond* may be exchanged.

Convertible bond Bond that may be converted into another security at the holder's option. Similarly convertible *preferred stock*.

Convexity Term often used to describe the fact that the effect of an interest rate change on *bond* prices declines as the interest rate rises.

Correlation coefficient Measure of the closeness of the relationship between two variables.

Cost company arrangement Arrangement whereby the shareholders of a project receive output free of charge but agree to pay all operating and financing charges of the project.

Cost of capital *Opportunity cost of capital.*

Coupon (1) Specifically, an attachment to the certificate of a *bearer security* that must be surrendered to collect interest payment; (2) more generally, interest payment on debt.

Covariance Measure of the comovement between two variables.

Covenant Clause in a loan agreement.

Credit derivative Contract for *hedging* against loan default or changes in credit risk (see *default swap*, *credit option*).

Credit option Similar to a long-term insurance policy against loan default.

Credit scoring A procedure for assigning scores to borrowers on the basis of the risk of default.

Cross-default clause Clause in a loan agreement stating that the company is in default if it fails to meet its obligation on any other debt issue.

Cum dividend *With dividend.*

Cum rights *With rights.*

Cumulative preferred stock Stock that takes priority over *common stock* in regard to dividend payments. Dividends

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may not be paid on the common stock until all past *dividends* on the *preferred stock* have been paid.

Cumulative voting Voting system under which a stockholder may cast all of his or her votes for one candidate for the board of directors (cf. *majority voting*).

Current asset Asset that will normally be turned into cash within a year.

Current liability Liability that will normally be repaid within a year.

Current ratio *Current assets* divided by *current liabilities*—a measure of liquidity.

D

DCF *Discounted cash flow*.

Debenture Unsecured *bond*.

Decision tree Method of representing alternative sequential decisions and the possible outcomes from these decisions.

Default swap *Credit derivative* in which one party makes fixed payments while the payments by the other party depend on the occurrence of a loan default.

Defeasance Practice whereby the borrower sets aside cash or *bonds* sufficient to service the borrower's debt. Both the borrower's debt and the offsetting cash or bonds are removed from the balance sheet.

Delta *Hedge ratio*.

Depository transfer check (DTC) Check made out directly by a local bank to a particular company.

Depreciation (1) Reduction in the book or market value of an asset; (2) portion of an investment that can be deducted from taxable income.

Derivative Asset whose value derives from that of some other asset (e.g., a *future* or an *option*).

Diff *Differential swap*.

Differential swap (diff, quanto swap) Swap between two *LIBOR* rates of interest, e.g., yen *LIBOR* for dollar *LIBOR*. Payments are in one currency.

Dilution Diminution in the proportion of income to which each share is entitled.

Direct lease *Lease* in which the *lessor* purchases new equipment from the manufacturer and leases it to the *lessee* (cf. *sale and lease-back*).

Direct quote For foreign exchange, the number of U.S. dollars needed to buy one unit of a foreign currency (cf. *indirect quote*).

Dirty price *Bond* price including *accrued interest*, i.e., the price paid by the bond buyer (cf. *clean price*).

Discount bond Debt sold for less than its *principal* value. If a discount bond pays no interest, it is called a "pure" discount, or *zero-coupon*, bond.

Discounted cash flow (DCF) Future cash flows multiplied by *discount factors* to obtain *present value*.

Discount factor *Present value* of \$1 received at a stated future date.

Discount rate Rate used to calculate the *present value* of future cash flows.

Discriminatory price auction Auction in which successful bidders pay the price that they bid (cf. *uniform price auction*).

Disintermediation Withdrawal of funds from a financial institution in order to invest them directly (cf. *intermediation*).

Dividend Payment by a company to its stockholders.

Dividend reinvestment plan (DRIP) Plan that allows shareholders to reinvest dividends automatically.

Dividend yield Annual *dividend* divided by share price.

Double-declining-balance depreciation Method of *accelerated depreciation*.

Double-tax agreement Agreement between two countries that taxes paid abroad can be offset against domestic taxes levied on foreign *dividends*.

Down-and-in option *Barrier option* that comes into existence if asset price hits a barrier.

Down-and-out option *Barrier option* that expires if asset price hits a barrier.

DRIP *Dividend reinvestment plan*.

Drop lock An arrangement whereby the interest rate on a *floating-rate note* or *preferred stock* becomes fixed if it falls to a specified level.

DTC *Depository transfer check*.

Dual-currency bond *Bond* with interest paid in one currency and *principal* paid in another.

Duration The average number of years to an asset's *discounted cash flows*.

E

EBIT Earnings before interest and taxes.

Economic exposure Risk that arises from changes in real exchange rates (cf. *transaction exposure*, *translation exposure*).

Economic income Cash flow plus change in *present value*.

Economic rents Profits in excess of the competitive level.

Economic Value Added (EVA) A measure of *residual income* implemented by the consulting firm Stern Stewart.

Efficient market Market in which security prices reflect information instantaneously.

Efficient portfolio Portfolio that offers the lowest risk (*standard deviation*) for its *expected return* and the highest expected return for its level of risk.

Employee stock ownership plan (ESOP) A company contributes to a trust fund that buys stock on behalf of employees.

EPS Earnings per share.

Equipment trust certificate Form of *secured debt* generally used to finance railroad equipment. The trustee retains ownership of the equipment until the debt is repaid.

Equity (1) *Common stock* and *preferred stock*. Often used to refer to common stock only. (2) *Net worth*.

Equivalent annual cash flow *Annuity* with the same *net present value* as the company's proposed investment.

ESOP *Employee stock ownership plan*.

Euribor *Euro Interbank Offered Rate*.

Euro Interbank Offered Rate (Euribor) The interest rate at which major international banks in Europe lend euros to each other.

Eurobond *Bond* that is marketed internationally.

Eurodollar deposit Dollar deposit with a bank outside the United States.

European option *Option* that can be exercised only on final exercise date (cf. *American option*).

EVA *Economic Value Added*.

Evergreen credit *Revolving credit* without maturity.

Exchange of assets Acquisition of another company by purchase of its assets in exchange for cash or shares.

Exchange of stock Acquisition of another company by purchase of its stock in exchange for cash or shares.

Ex dividend Purchase of shares in which the buyer is not entitled to the forthcoming *dividend* (cf. *with dividend*, *cum dividend*).

Exercise price (striking price) Price at which a *call option* or *put option* may be exercised.

Expectations hypothesis Theory that *forward interest rate* (*forward exchange rate*) equals expected *spot rate*.

Expected return Average of possible returns weighted by their probabilities.

Ex rights Purchase of shares in which the buyer is not entitled to the rights to buy shares in the company's *rights issue* (cf. *with rights*, *cum rights*, *rights on*).

Extendable bond *Bond* whose maturity can be extended at the option of the lender (or issuer).

External finance Finance that is not generated by the firm: new borrowing or an issue of stock (cf. *internal finance*).

Extra dividend *Dividend* that may or may not be repeated (cf. *regular dividend*).

F

Face value *Par value*.

Factoring Arrangement whereby a financial institution buys a company's *accounts receivable* and collects the debt.

Fair price provision *Appraisal rights*.

FASB Financial Accounting Standards Board.

FCIA Foreign Credit Insurance Association.

FDIC Federal Deposit Insurance Corporation.

Federal funds Non-interest-bearing deposits by banks at the Federal Reserve. Excess reserves are lent by banks to each other.

Fedwire A wire transfer system for high-value payments operated by the Federal Reserve System (cf. *CHIPS*).

Field warehouse Warehouse rented by a warehouse company on another firm's premises (cf. *public warehouse*).

Financial assets Claims on *real assets*.

Financial engineering Combining or dividing existing instruments to create new financial products.

Financial lease (capital lease, full-payout lease) Long-term, noncancelable *lease* (cf. *operating lease*).

Financial leverage (gearing) Use of debt to increase the *expected return* on *equity*. Financial leverage is measured by the ratio of debt to debt plus equity (cf. *operating leverage*).

Fiscal agency agreement An alternative to a bond *trust deed*. Unlike the trustee, the fiscal agent acts as an agent of the borrower.

Flat price *Clean price*.

Float *See availability float, payment float*.

Floating lien General *lien* against a company's assets or against a particular class of assets.

Floating-rate note (FRN) *Note* whose interest payment varies with the short-term interest rate.

Floating-rate preferred *Preferred stock* paying dividends that vary with short-term interest rates.

Floor planning Arrangement used to finance inventory. A finance company buys the inventory, which is then held in trust by the user.

Foreign bond A *bond* issued on the domestic *capital market* of another country.

Forex Foreign exchange.

Forfeiter Purchaser of promises to pay (e.g., *bills of exchange* or *promissory notes*) issued by importers.

Forward cover Purchase or sale of forward foreign currency in order to offset a known future cash flow.

Forward exchange rate Exchange rate fixed today for exchanging currency at some future date (cf. *spot exchange rate*).

Forward interest rate Interest rate fixed today on a loan to be made at some future date (cf. *spot interest rate*).

Forward rate agreement (FRA) Agreement to borrow or lend at a specified future date at an interest rate that is fixed today.

FRA *Forward rate agreement*.

Free cash flow Cash not required for operations or for reinvestment.

FRN *Floating-rate note*.

Full-payout lease *Financial lease*.

Full-service lease (rental lease) *Lease* in which the *lessor* promises to maintain and insure the equipment (cf. *net lease*).

Fundamental analysis Security analysis that seeks to detect misvalued securities by an analysis of the firm's business prospects (cf. *technical analysis*).

Funded debt Debt maturing after more than one year (cf. *unfunded debt*).

Future A contract to buy a commodity or security on a future date at a price that is fixed today. Unlike forward contracts, futures are generally traded on organized exchanges and are *marked to market* daily.

G

GAAP Generally accepted accounting principles.

Gearing *Financial leverage*.

General cash offer Issue of securities offered to all investors (cf. *rights issue*).

Golden parachute A large termination payment due to a company's management if they lose their jobs as a result of a merger.

Goodwill The difference between the amount paid for a firm in a *merger* and its book value.

Gray market Purchases and sales of *eurobonds* that occur before the issue price is made.

Greenmail Situation in which a large block of stock is held by an unfriendly company, forcing the target company to repurchase the stock at a substantial premium to prevent a takeover.

Greenshoe option *Option* that allows the *underwriter* for a new issue to buy and resell additional shares.

Growth stock *Common stock* of a company that has an opportunity to invest money to earn more than the *opportunity cost of capital* (cf. *income stock*).

H

Haircut An additional margin of *collateral* for a loan.

Hedge ratio (delta, option delta) The number of shares to buy for each *option* sold in order to create a safe position; more generally, the number of units of an asset that should be bought to hedge one unit of a liability.

Hedging Buying one security and selling another in order to reduce risk. A perfect hedge produces a riskless portfolio.

Hell-or-high-water clause Clause in a *lease* agreement that obligates the *lessee* to make payments regardless of what happens to the *lessor* or the equipment.

Highly leveraged transaction (HLT) Bank loan to a highly leveraged firm (formerly needed to be separately reported to the Federal Reserve Board).

HLT *Highly leveraged transaction*.

Holding company Company whose sole function is to hold stock in other companies or subsidiaries.

Horizontal merger Merger between two companies that manufacture similar products (cf. *vertical merger*, *conglomerate merger*).

Horizontal spread The simultaneous purchase and sale of two *options* that differ only in their exercise date (cf. *vertical spread*).

Hurdle rate Minimum acceptable rate of return on a project.

I

IBF *International Banking Facility*.

IMM *International Monetary Market*.

Immunization The construction of an asset and a liability that are subject to offsetting changes in value.

Imputation tax system Arrangement by which investors who receive a *dividend* also receive a tax credit for corporate taxes that the firm has paid.

Income bond *Bond* on which interest is payable only if earned.

Income stock *Common stock* with high *dividend yield* and few profitable investment opportunities (cf. *growth stock*).

Indenture Formal agreement, e.g., establishing the terms of a *bond* issue.

Indexed bond *Bond* whose payments are linked to an index, e.g., a consumer price index (see *TIPs*).

Index fund Investment fund designed to match the returns on a stockmarket index.

Indirect quote For foreign exchange, the number of units of a foreign currency needed to buy one U.S. dollar (cf. *direct quote*).

Industrial revenue bond (IRB) Bond issued by local government agencies on behalf of corporations.

Initial public offering (IPO) A company's first public issue of *common stock*.

In-substance defeasance *Defeasance* whereby debt is removed from the balance sheet but not canceled (cf. *novation*).

Intangible asset Nonmaterial asset, such as technical expertise, a trademark, or a patent (cf. *tangible asset*).

Integer programming Variant of *linear programming* whereby the solution values must be integers.

Interest cover *Times interest earned*.

Interest equalization tax Tax on foreign investment by residents of the United States (abolished 1974).

Interest-rate parity Theory that the differential between the *forward exchange rate* and the *spot exchange rate* is equal to the differential between the foreign and domestic interest rates.

Intermediation Investment through a financial institution (cf. *disintermediation*).

Internal finance Finance generated within a firm by *retained earnings* and *depreciation* (cf. *external finance*).

Internal growth rate The maximum rate of firm growth without *external finance* (cf. *sustainable growth rate*).

Internal rate of return (IRR) *Discount rate* at which investment has zero *net present value*.

International Banking Facility (IBF) A branch that an American bank establishes in the United States to do eurocurrency business.

International Monetary Market (IMM) The financial futures market within the Chicago Mercantile Exchange.

Interval measure The number of days that a firm can finance operations without additional cash income.

In-the-money option An *option* that would be worth exercising if it expired immediately (cf. *out-of-the-money option*).

Inverse FRN *Floating-rate note* whose payments rise as the general level of interest rates falls and vice versa.

Investment-grade bond *Bond* rated at least Baa by Moody's or BBB by Standard and Poor's.

Investment tax credit Proportion of new capital investment that can be used to reduce a company's tax bill (abolished 1986).

IPO *Initial public offering*.

IRB *Industrial revenue bond*.

IRR *Internal rate of return*.

IRS Internal Revenue Service.

ISDA International Swap and Derivatives Association.

ISMA International Securities Market Association.

Issued share capital Total amount of shares that are in issue (cf. *outstanding share capital*).

J

Junior debt *Subordinated debt*.

Junk bond Debt that is rated below an *investment-grade bond*.

K

Keiretsu A network of Japanese companies organized around a major bank.

L

LBO *Leveraged buyout*.

Lease Long-term rental agreement.

Legal capital Value at which a company's shares are recorded in its books.

Legal defeasance *Novation*.

Lessee User of a leased asset (cf. *lessor*).

Lessor Owner of a leased asset (cf. *lessee*).

Letter of credit Letter from a bank stating that it has established a credit in the company's favor.

Letter stock Privately placed *common stock*, so-called because the SEC requires a letter from the purchaser that the stock is not intended for resale.

Leverage See *financial leverage*, *operating leverage*.

Leveraged buyout (LBO) Acquisition in which (1) a large part of the purchase price is debt-financed and (2) the remaining *equity* is privately held by a small group of investors.

Leveraged lease *Lease* in which the *lessor* finances part of the cost of the asset by an issue of debt secured by the asset and the lease payments.

Liabilities, total liabilities Total value of financial claims on a firm's assets. Equals (1) total assets or (2) total assets minus *net worth*.

LIBOR *London interbank offered rate*.

Lien Lender's claims on specified assets.

Limited liability Limitation of a shareholder's losses to the amount invested.

Limited partnership *Partnership* in which some partners have *limited liability* and general partners have unlimited liability.

Linear programming (LP) Technique for finding the maximum value of some equation subject to stated linear constraints.

Line of credit Agreement by a bank that a company may borrow at any time up to an established limit.

Liquid asset Asset that is easily and cheaply turned into cash—notably cash itself and short-term securities.

Liquidating dividend *Dividend* that represents a return of capital.

Liquidator Person appointed by unsecured creditors in the United Kingdom to oversee the sale of an insolvent firm's assets and the repayment of debts.

Liquidity premium (1) Additional return for investing in a security that cannot easily be turned into cash; (2) difference between the *forward interest rate* and the expected *spot interest rate*.

Liquid yield option note (LYON) *Zero-coupon*, callable, puttable, *convertible bond*.

Load-to-load Arrangement whereby the customer pays for the last delivery when the next one is received.

Lock-box system Form of *concentration banking*. Customers send payments to a post office box. A local bank collects and processes the checks and transfers surplus funds to the company's principal bank.

London interbank offered rate (LIBOR) The interest rate at which major international banks in London lend to each other. (LIBID is London interbank bid rate; LIMEAN is mean of bid and offered rate.)

Long hedge Purchase of a *hedging* instrument (e.g., a *future*) to hedge a short position in the underlying asset (cf. *short hedge*).

Lookback option *Option* whose payoff depends on the highest asset price recorded over the life of the option.

LP *Linear programming*.

LYON *Liquid yield option note*.

M

MACRS *Modified accelerated cost recovery system*.

Maintenance margin Minimum margin that must be maintained on a *futures* contract.

Majority voting Voting system under which each director is voted upon separately (cf. *cumulative voting*).

Management buyout (MBO) *Leveraged buyout* whereby the acquiring group is led by the firm's management.

Margin Cash or securities set aside by an investor as evidence that he or she can honor a commitment.

Marked-to-market An arrangement whereby the profits or losses on a *futures* contract are settled up each day.

Market capitalization rate *Expected return* on a security.

Market risk (systematic risk) Risk that cannot be diversified away.

Maturity factoring *Factoring* arrangement that provides collection and insurance of *accounts receivable*.

MBO *Management buyout*.

MDA *Multiple-discriminant analysis*.

Medium-term note (MTN) Debt with a typical maturity of 1 to 10 years offered regularly by a company using the same procedure as *commercial paper*.

Merger (1) Acquisition in which all assets and liabilities are absorbed by the buyer (cf. *exchange of assets, exchange of stock*); (2) more generally, any combination of two companies.

MIP (Monthly income preferred security) *Preferred stock* issued by a subsidiary located in a tax haven. The subsidiary relends the money to the parent.

Mismatch bond *Floating-rate note* whose interest rate is reset at more frequent intervals than the rollover period (e.g., a note whose payments are set quarterly on the basis of the one-year interest rate).

Modified accelerated cost recovery system (MACRS) Schedule of *depreciation* deductions allowed for tax purposes.

Money center bank A major U.S. bank that undertakes a wide range of banking activities.

Money market Market for short-term safe investments.

Money-market fund *Mutual fund* that invests solely in short-term safe securities.

Monte Carlo simulation Method for calculating the probability distribution of possible outcomes, e.g., from a project.

Moral hazard The risk that the existence of a contract will change the behavior of one or both parties to the contract; e.g., an insured firm may take fewer fire precautions.

Mortgage bond *Bond* secured against plant and equipment.

MTN *Medium-term note*.

Multiple-discriminant analysis (MDA) Statistical technique for distinguishing between two groups on the basis of their observed characteristics.

Mutual fund Managed investment fund whose shares are sold to investors.

Mutually exclusive projects Two projects that cannot both be undertaken.

N

Naked option *Option* held on its own, i.e., not used for *hedging* a holding in the asset or other options.

NASD National Association of Security Dealers.

Negative pledge clause Clause under which the borrower agrees not to permit an exclusive *lien* on any of its assets.

Negotiated underwriting Method of choosing an *underwriter*. Most firms may choose their *underwriter* by negotiation (cf. *competitive bidding*).

Net lease *Lease* in which the *lessee* promises to maintain and insure the equipment (cf. *full-service lease*).

Net present value (NPV) A project's net contribution to wealth—*present value* minus initial investment.

Net working capital *Current assets* minus *current liabilities*.

Net worth Book value of a company's *common stock*, surplus, and *retained earnings*.

Nominal interest rate Interest rate expressed in money terms (cf. *real interest rate*).

Nonrefundable debt Debt that may not be called in order to replace it with another issue at a lower interest cost.

Normal distribution Symmetric bell-shaped distribution that can be completely defined by its mean and *standard deviation*.

Note Unsecured debt with a maturity of up to 10 years.

Novation (legal defeasance) *Defeasance* whereby the firm's debt is canceled (cf. *in-substance defeasance*).

NPV *Net present value*.

NYSE New York Stock Exchange.

O

Odd lot A trade of less than 100 shares (cf. *round lot*).

Off-balance-sheet financing Financing that is not shown as a liability in a company's balance sheet.

Offer price *Ask price*.

OID debt *Original issue discount debt*.

Old-line factoring *Factoring* arrangement that provides collection, insurance, and finance for *accounts receivable*.

On the run The most recently issued (and, therefore, typically the most liquid) government *bond* in a particular maturity range.

Open account Arrangement whereby sales are made with no formal debt contract. The buyer signs a receipt, and the seller records the sale in the sales ledger.

Open-end mortgage Mortgage against which additional debt may be issued (cf. *closed-end mortgage*).

Open interest The number of currently outstanding *futures* contracts.

Operating lease Short-term, cancelable *lease* (cf. *financial lease*).

Operating leverage Fixed operating costs, so-called because they accentuate variations in profits (cf. *financial leverage*).

Opportunity cost of capital (hurdle rate, cost of capital) *Expected return* that is forgone by investing in a project rather than in comparable financial securities.

Option See *call option*, *put option*.

Option delta *Hedge ratio*.

Original issue discount debt (OID debt) Debt that is initially offered at a price below *face value*.

OTC *Over-the-counter*.

Out-of-the-money option An *option* that would not be worth exercising if it matured immediately (cf. *in-the-money option*).

Outstanding share capital *Issued share capital* less the *par value* of shares that are held in the company's treasury.

Oversubscription privilege In a *rights issue*, arrangement by which shareholders are given the right to apply for any shares that are not taken up.

Over-the-counter (OTC) Informal market that does not involve a securities exchange. Specifically used to refer to the NASDAQ dealer market for *common stocks*.

P

Partnership Joint ownership of business whereby general partners have unlimited liability.

Par value (face value) Value of a security shown on the certificate.

Pass-through securities *Notes* or *bonds* backed by a package of assets (e.g., mortgage pass-throughs, CARs, CARS).

Path-dependent option *Option* whose value depends on the sequence of prices of the underlying asset rather than just the final price of the asset.

Payables *Accounts payable*.

Payback period Time taken for a project to recover its initial investment.

Pay-in-kind bond (PIK) *Bond* that allows the issuer to choose to make interest payments in the form of additional bonds.

Payment float Company-written checks that have not yet cleared (cf. *availability float*).

Payout ratio *Dividend* as a proportion of earnings per share.

PBGC Pension Benefit Guarantee Corporation.

P/E ratio Share price divided by earnings per share.

PERC (Preferred equity redemption cumulative stock) *Preferred stock* that converts automatically into equity at a stated date. A limit is placed on the value of the shares that the investor receives.

Perpetuity Investment offering a level stream of cash flows in perpetuity (cf. *consol*).

PIK *Pay-in-kind bond*.

PN *Project note*.

Poison pill An issue of securities that is convertible, in the event of a *merger*, into the shares of the acquiring firm or must be repurchased by the acquiring firm.

Poison put A *covenant* allowing the *bondholder* to demand repayment in the event of a hostile *merger*.

Pooling of interest Method of accounting for *mergers* (no longer available in the USA). The consolidated balance sheet of the merged firm is obtained by combining the balance sheets of the separate firms (cf. *purchase accounting*).

Position diagram Diagram showing the possible payoffs from a *derivative* investment.

Postaudit Evaluation of an investment project after it has been undertaken.

Preemptive right Common stockholder's right to anything of value distributed by the company.

Preferred stock Stock that takes priority over common stock in regard to *dividends*. Dividends may not be paid on *common stock* unless the dividend is paid on all preferred stock (cf. *cumulative preferred stock*). The dividend rate on preferred is usually fixed at time of issue.

Prepack *Prepackaged bankruptcy*.

Prepackaged bankruptcy (prepack) Bankruptcy proceedings intended to confirm a reorganization plan that has already been agreed to informally.

Present value Discounted value of future cash flows.

Present value of growth opportunities (PVGO) *Net present value* of investments the firm is expected to make in the future.

PRIDE Similar to a *PERC* except that as the equity price rises beyond a specified point, the investor shares in the stock appreciation.

Primary issue Issue of new securities by a firm (cf. *secondary issue*).

Prime rate Benchmark lending rate set by U.S. banks.

Principal Amount of debt that must be repaid.

Principal–agent problem Problem faced by a principal (e.g., shareholder) in ensuring that an agent (e.g., manager) acts on his or her behalf.

Privileged subscription issue *Rights issue.*

Production payment Loan in the form of advance payment for future delivery of a product.

Profitability index Ratio of a project's *NPV* to the initial investment.

Pro forma Projected.

Project finance Debt that is largely a claim against the cash flows from a particular project rather than against the firm as a whole.

Project note (PN) Note issued by public housing or urban renewal agencies.

Promissory note Promise to pay.

Prospectus Summary of the *registration* statement providing information on an issue of securities.

Proxy vote Vote cast by one person on behalf of another.

Public warehouse (terminal warehouse) Warehouse operated by an independent warehouse company on its own premises (cf. *field warehouse*).

Purchase accounting Method of accounting for *mergers*. The assets of the acquired firm are shown at market value on the balance sheet of the acquiror (cf. *pooling of interest*).

Purchase fund Resembles a *sinking fund* except that money is used only to purchase bonds if they are selling below their *par value*.

Put option Option to sell an asset at a specified *exercise price* on or before a specified exercise date (cf. *call option*).

PVGO *Present value of growth opportunities.*

Q

q Ratio of the market value of an asset to its replacement cost.

QIBs *Qualified Institutional Buyers.*

Quadratic programming Variant of *linear programming* whereby the equations are quadratic rather than linear.

Qualified Institutional Buyers (QIBs) Institutions that are allowed to trade unregistered stock among themselves.

Quanto swap *Differential swap.*

Quick ratio (acid-test ratio) Measure of liquidity: (*current assets* – inventory) divided by *current liabilities*.

R

Range forward A *forward exchange rate* contract that places upper and lower bounds on the cost of foreign exchange.

Real assets *Tangible assets* and *intangible assets* used to carry on business (cf. *financial assets*).

Real estate investment trust (REIT) Trust company formed to invest in real estate.

Real interest rate Interest rate expressed in terms of real goods, i.e., *nominal interest rate* adjusted for inflation.

Receivables *Accounts receivable.*

Receiver A bankruptcy practitioner appointed by secured creditors in the United Kingdom to oversee the repayment of debts.

Record date Date set by directors when making dividend payment. *Dividends* are sent to stockholders who are registered on the record date.

Recourse Term describing a type of loan. If a loan is with recourse, the lender has a general claim against the parent company if the *collateral* is insufficient to repay the debt.

Red herring Preliminary *prospectus*.

Refunding Replacement of existing debt with a new issue of debt.

Registered security Security whose ownership is recorded by the company's *registrar* (cf. *bearer security*).

Registrar Financial institution appointed to record issue and ownership of company securities.

Registration Process of obtaining *SEC* approval for a public issue of securities.

Regression analysis In statistics, a technique for finding the line of best fit.

Regular dividend *Dividend* that the company expects to maintain in the future.

Regulation A issue Small security issues that are partially exempt from *SEC registration* requirements.

REIT *Real estate investment trust.*

Rental lease *Full-service lease.*

Repo *Repurchase agreement.*

Repurchase agreement (RP, repo, buy-back) Purchase of Treasury securities from a securities dealer with an agreement that the dealer will repurchase them at a specified price.

Residual income After-tax profit less the *opportunity cost of capital* employed by the business (see also *Economic Value Added*).

Residual risk *Unique risk.*

Retained earnings Earnings not paid out as *dividends*.

Return on equity Usually, equity earnings as a proportion of the book value of equity.

Return on investment (ROI) Generally, book income as a proportion of net book value.

Revolving credit Legally assured *line of credit* with a bank.

Rights issue (privileged subscription issue) Issue of securities offered to current stockholders (cf. *general cash offer*).

Rights on *With rights.*

Risk premium Expected additional return for making a risky investment rather than a safe one.

ROI *Return on investment.*

Roll-over CD A package of successive *certificates of deposit*.

Round lot A trade of 100 shares (cf. *odd lot*).

RP *Repurchase agreement.*

R squared (R^2) Square of the *correlation coefficient*—the proportion of the variability in one series that can be explained by the variability of one or more other series.

Rule 144a SEC rule allowing *qualified institutional buyers* to buy and trade unregistered securities.

S

Sale and lease-back Sale of an existing asset to a financial institution that then *leases* it back to the user (cf. *direct lease*).

Salvage value Scrap value of plant and equipment.

Samurai bond A yen *bond* issued in Tokyo by a non-Japanese borrower (cf. *bulldog bond*, *Yankee bond*).

SBIC Small Business Investment Company.

Seasoned issue Issue of a security for which there is an existing market (cf. *unseasoned issue*).

Season datings Extended credit for customers who order goods out of the peak season.

SEC Securities and Exchange Commission.

Secondary issue (1) Procedure for selling blocks of *seasoned issues* of stock; (2) more generally, sale of already issued stock.

Secondary market Market in which one can buy or sell *seasoned issues* of securities.

Secured debt Debt that, in the event of default, has first claim on specified assets.

Securitization Substitution of tradable securities for privately negotiated instruments.

Security market line Line representing the relationship between *expected return* and *market risk*.

Self-liquidating loan Loan to finance *current assets*. The sale of the current assets provides the cash to repay the loan.

Self-selection Consequence of a contract that induces only one group (e.g., low-risk individuals) to participate.

Semistrong-form efficient market Market in which security prices reflect all publicly available information (cf. *weak-form efficient market* and *strong-form efficient market*).

Senior debt Debt that, in the event of bankruptcy, must be repaid before *subordinated debt* receives any payment.

Sensitivity analysis Analysis of the effect on project profitability of possible changes in sales, costs, and so on.

Serial bonds Package of *bonds* that mature in successive years.

Series bond *Bond* that may be issued in several series under the same *indenture*.

Shark repellent Amendment to company charter intended to protect against takeover.

Shelf registration A procedure that allows firms to file one *registration* statement covering several issues of the same security.

Shogun bond Dollar *bond* issued in Japan by a nonresident.

Short hedge Sale of a *hedging* instrument (e.g., a *future*) to *hedge* a long position in the underlying asset (cf. *long hedge*).

Short sale Sale of a security the investor does not own.

Sight draft Demand for immediate payment (cf. *time draft*).

Signal Action that demonstrates an individual's unobservable characteristics (because it would be unduly costly for someone without those characteristics to take the action).

Simple interest Interest calculated only on the initial investment (cf. *compound interest*).

Simulation *Monte Carlo simulation*.

Sinker *Sinking fund*.

Sinking fund (sinker) Fund established by a company to retire debt before maturity.

Skewed distribution Probability distribution in which an unequal number of observations lie below and above the mean.

Special dividend (extra dividend) *Dividend* that is unlikely to be repeated.

Specific risk *Unique risk*.

Spin-off Distribution of shares in a subsidiary to the company's shareholders so that they hold shares separately in the two firms.

Spot exchange rate Exchange rate on currency for immediate delivery (cf. *forward exchange rate*).

Spot interest rate Interest rate fixed today on a loan that is made today (cf. *forward interest rate*).

Spot price Price of asset for immediate delivery (in contrast to forward or futures price).

Spread Difference between the price at which an *underwriter* buys an issue from a firm and the price at which the underwriter sells it to the public.

Standard deviation Square root of the *variance*—a measure of variability.

Standard error In statistics, a measure of the possible error in an estimate.

Standby agreement In a *rights issue*, agreement that the *underwriter* will purchase any stock not purchased by investors.

Step-up bond *Bond* whose *coupon* is stepped up over time (also step-down bond).

Stock dividend *Dividend* in the form of stock rather than cash.

Stock split "Free" issue of shares to existing shareholders.

Straddle The combination of a *put option* and a *call option* with the same *exercise price*.

Straight-line depreciation An equal dollar amount of *depreciation* in each period.

Striking price *Exercise price* of an *option*.

Stripped bond *Bond* that can be subdivided into a series of *zero-coupon bonds*.

Strong-form efficient market Market in which security prices reflect instantaneously *all* information available to investors (cf. *weak-form efficient market* and *semistrong-form efficient market*).

Structured debt Debt that has been customized for the buyer, often by incorporating unusual *options*.

Subordinated debt (junior debt) Debt over which *senior debt* takes priority. In the event of bankruptcy, subordinated debtholders receive payment only after senior debt is paid off in full.

Sum-of-the-years'-digits depreciation Method of *accelerated depreciation*.

Sunk costs Costs that have been incurred and cannot be reversed.

Supermajority Provision in a company's charter requiring a majority of, say, 80 percent of shareholders to approve certain changes, such as a *merger*.

Sushi bond A *eurobond* issued by a Japanese corporation.

Sustainable growth rate Maximum rate of firm growth without increasing financial leverage (cf. *internal growth rate*).

Swap An arrangement whereby two companies lend to each other on different terms, e.g., in different currencies, or one at a fixed rate and the other at a floating rate.

Swaption *Option* on a *swap*.

Swingline facility Bank borrowing facility to provide finance while the firm replaces U.S. *commercial paper* with eurocommercial paper.

Systematic risk *Market risk*.

T

Take-up fee Fee paid to *underwriters* of a *rights issue* on any stock they are obliged to purchase.

Tangible asset Physical asset, such as plant, machinery, and offices (cf. *intangible assets*).

Tax-anticipation bill Short-term bill issued by the U.S. Treasury that can be surrendered at *face value* in payment of taxes.

T-bill *Treasury bill*.

Technical analysis Security analysis that seeks to detect and interpret patterns in past security prices (cf. *fundamental analysis*).

TED spread Difference between *LIBOR* and U.S. *Treasury bill* rate.

Tender offer General offer made directly to a firm's shareholders to buy their stock.

Tenor Maturity of a loan.

Terminal warehouse *Public warehouse*.

Term loan Medium-term, privately placed loan, usually made by a bank.

Term structure of interest rates Relationship between interest rates on loans of different maturities (cf. *yield curve*).

Throughput arrangement Arrangement by which shareholders of a pipeline company agree to make sufficient use of pipeline to enable the pipeline company to service its debt.

Tick Minimum amount the price of a security may change.

Time draft Demand for payment at a stated future date (cf. *sight draft*).

Times interest earned (interest cover) Earnings before interest and tax, divided by interest payments.

TIPS (Treasury Inflation Protected Securities) U.S. Treasury *bonds* whose *coupon* and *principal* payments are linked to the Consumer Price Index.

Tombstone Advertisement listing the *underwriters* to a security issue.

Trade acceptance Written demand that has been accepted by an industrial company to pay a given sum at a future date (cf. *banker's acceptance*).

Trade credit *Accounts receivable*.

Trade debt *Accounts payable*.

Tranche Portion of a new issue sold at a point in time different from the remainder or that has different terms.

Transaction exposure Risk to a firm with known future cash flows in a foreign currency that arises from possible changes in the exchange rate (cf. *economic exposure*, *translation exposure*).

Transfer agent Individual or institution appointed by a company to look after the transfer of securities.

Translation exposure Risk of adverse effects on a firm's financial statements that may arise from changes in exchange rates (cf. *economic exposure*, *transaction exposure*).

Treasurer Principal financial manager (cf. *controller*).

Treasury bill (T-bill) Short-term discount debt maturing in less than one year, issued regularly by the government.

Treasury stock *Common stock* that has been repurchased by the company and held in the company's treasury.

Trust deed Agreement between trustee and borrower setting out terms of *bond*.

Trust receipt Receipt for goods that are to be held in trust for the lender.

U

Underpricing Issue of securities below their market value.

Underwriter Firm that buys an issue of securities from a company and resells it to investors.

Unfunded debt Debt maturing within one year (cf. *funded debt*).

Uniform price auction Auction in which all successful bidders pay the same price (cf. *discriminatory price auction*).

Unique risk (residual risk, specific risk, unsystematic risk) Risk that can be eliminated by diversification.

Unseasoned issue Issue of a security for which there is no existing market (cf. *seasoned issue*).

Unsystematic risk *Unique risk*.

V

Value additivity Rule that the value of the whole must equal the sum of the values of the parts.

Value-at-risk model (VAR model) Procedure for estimating the probability of portfolio losses exceeding some specified proportion.

Vanilla issue Issue without unusual features.

Variable-rate demand bond (VRDB) Floating-rate *bond* that can be sold back periodically to the issuer.

Variance Mean squared deviation from the expected value—a measure of variability.

Variation margin The daily gains or losses on a *futures* contract credited to the investor's margin account.

VAR model *Value-at-risk model*.

Venture capital Capital to finance a new firm.

Vertical merger *Merger* between a supplier and its customer (cf. *horizontal merger, conglomerate merger*).

Vertical spread Simultaneous purchase and sale of two options that differ only in their *exercise price* (cf. *horizontal spread*).

VRDB *Variable rate demand bond*.

W

WACC *Weighted-average cost of capital*.

Warehouse receipt Evidence that a firm owns goods stored in a warehouse.

Warrant Long-term *call option* issued by a company.

Weak-form efficient market Market in which security prices instantaneously reflect the information in the history of security prices. In such a market security prices follow a random walk (cf. *semistrong-form efficient market* and *strong-form efficient market*).

Weighted-average cost of capital (WACC) *Expected return* on a portfolio of all the firm's securities. Used as *hurdle rate* for capital investment.

White knight A friendly potential acquirer sought out by a target company threatened by a less welcome suitor.

Wi. When issued.

Winner's curse Problem faced by uninformed bidders. For example, in an *initial public offering* uninformed participants are likely to receive larger allotments of issues that informed participants know are overpriced.

With dividend (cum dividend) Purchase of shares in which the buyer is entitled to the forthcoming *dividend* (cf. *ex dividend*).

Withholding tax Tax levied on *dividends* paid abroad.

With rights (cum rights, rights on) Purchase of shares in which the buyer is entitled to the rights to buy shares in the company's *rights issue* (cf. *ex rights*).

Working capital *Current assets* and *current liabilities*. The term is commonly used as synonymous with *net working capital*.

Workout Informal arrangement between a borrower and creditors.

Writer *Option seller*.

Y

Yankee bond A dollar *bond* issued in the United States by a non-U.S. borrower (cf. *bulldog bond, Samurai bond*).

Yield curve *Term structure of interest rates*.

Yield to maturity *Internal rate of return* on a bond.

Z

Zero-coupon bond *Discount bond* making no *coupon* payments.

Z score Measure of the likelihood of bankruptcy.