GLOSSARY

GLOSSARY OF TERMS

GLOSSARY

A

acceptor of a bill of exchange the party agreeing to pay the holder the face value of the bill on the maturity date, usually a bank or other financial institution Also known as the drawee

accounting break-even the sales level that results in zero project net profit

accounting rate of return (ARR) an investment's average net income divided by its average book value

accounts payable period the time between receipt of inventory and payment for it

accounts receivable period the time between sale of inventory and collection of the receivable

accumulation a process by which, through the operation of interest, a present sum becomes a greater sum in the future

acquisition/shortage costs costs that fall with increases in the level of investment in current assets

adjustment costs the costs associated with holding too little cash Also shortage costs

ageing schedule a compilation of accounts receivable by the age of each account

agency costs of debt these arise because equityholders may act in their own interest rather than the interests of the firm as a whole

agency problem the possibility of conflicts of interest between the shareholders and management of a firm

aggregation process by which smaller investment proposals of each of a firm's operational units are added up and treated as one big project

American option an option that can be exercised at any time until its expiration date

annual equivalent cost (AEC) the present value of a project's costs calculated on an annual basis

annuity a series of cash flows of equal amount, equally spaced in time

annuity-due an annuity in which the first cash flow is to occur at the beginning of the time period and the beginning of all subsequent periods

anomaly a finding that appears to be inconsistent with theory

appreciation the rise in the value of a currency in terms of another currency or currencies

arbitrage buying and simultaneously selling an asset for a higher price, usually in another market, so as to make a risk-free profit

Arrow's impossibility theorem when there is an imperfect market there is no longer a unique production decision that would be made by any current owner regardless of the preferences of the owner

at call money repayable immediately, whenever demanded by the lender
AUD (buying) rate the Australian dollar exchange rate at which a bank is willing to buy the currency
Australian Stock Exchange (ASX) Australia's central marketplace for companies raising funds
authorised foreign exchange dealers organisations granted a general authority to buy and sell foreign currency
average tax rate total taxes paid divided by total taxable income

B

bad debts debtors accounts that have proven to be non-collectable and are written off
balance sheet financial statement showing a firm's accounting value on a particular date
bank bill a bill of exchange that has been accepted or endorsed by a bank
bankruptcy bankruptcy is defined as a condition where all or part of the organisation's assets are transferred to creditors
basis the difference between the spot price and the future price (for delivery at some later date) at a point in time
bearer security a security whose ownership is not registered by the issuer and possession of the physical document is primary evidence of ownership
benefit/cost ratio the profitability index of an investment project Also present value index
beta coefficient amount of systematic risk present in a particular risky asset relative to an average risky asset
beta systematic risk divided by the standard deviation of return on the market
bill discount facility an agreement in which one entity (normally a bank) undertakes to discount (buy) bills of exchange drawn by another entity (the borrower)
bill facility an agreement in which one entity (normally a bank) undertakes to accept bills of exchange drawn by another entity (the borrower)
bill of exchange a negotiable instrument that involves a drawer, acceptor and payee
book-to-market ratio the book value of a company's equity divided by the market value of the company's equity
bonds loans made to a government body
bonds long-term debt securities
bonus share issue payment made by a firm to its owners in the form of shares, diluting the value of each share outstanding
book value accounting per share value of firm's equity Also net worth
bridging finance a short-term loan, usually in the form of a mortgage, to cover a need arising from timing differences between two or more transactions
business day a day in which banks are open for business For foreign exchange, this applies to banks in both the countries of the currencies being exchanged
business risk the equity risk that comes from the nature of the firm's operating activities
buy-and-hold policy an investment strategy in which shares are bought and then retained in the investor's portfolio
buyout a transfer of ownership to existing employees; usually identified as a management buyout

C

call option the right to buy an asset at a fixed price during a particular period
call premium amount by which the call price exceeds the paid-up value of the debenture
capital asset pricing model (CAPM) equation of the SML showing relationship between expected return and beta

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capital budgeting the process of planning and managing a firm's investment in non-current assets

capital gains yield the dividend growth rate or the rate at which the value of an investment grows

capital intensity ratio a firm's total assets divided by its sales, or the amount of assets needed to generate $1 in sales

capital markets financial markets where long-term debt and equity securities are bought and sold

capital market line (CML) describes the equilibrium relationship between expected return and total risk (standard deviation) when all of the risk is being rewarded because all of the risk is market related It is derived by summing the risk free rate and the product of the expected market premium for risk and the ratio of the efficient asset's standard deviation to the standard deviation of the expected market return

capital rationing the situation that exists if a firm has positive NPV projects but cannot find the necessary financing

capital structure the mix of debt and equity maintained by a firm

carrying costs costs that rise with increases in the level of investment in current assets

cash break-even the sales level where operating cash flow is equal to zero

cash budget a forecast of cash receipts and disbursements for the next planning period

cash cycle the time between cash disbursement and cash collection

cash discount a discount given for a cash purchase

cash flow a payment (cash outflow) or receipt (cash inflow) of money

cash flow from assets the total of cash flow to debtholders and cash flow to shareholders, consisting of the following: operating cash flow, capital spending and additions to net working capital

cash flow statement a firm's financial statement that summarises its sources and uses of cash over a specified period

cash flow time line graphical representation of the operating cycle and the cash cycle

cash flow to debtholders a firm's interest payments to lenders less net new borrowings

cash flow to shareholders dividends paid out by a firm less net equity raised

Certainty-equivalent an approach that incorporates risk by adjusting the cash flows by subtracting a risk premium and discounting using the risk free rate

certificate of deposit a marketable fixed rate debt instrument issued by a bank in exchange for a deposit of funds

clientele effect argument that stocks attract particular groups based on dividend yield and the resulting tax effects

CML the CML equation explains the expected return for efficient portfolios

collection policy procedures followed by a firm in collecting accounts receivable

commercial paper a U.S. term used to describe unsecured short-term promissory notes

company option a security that gives the holder the right to purchase shares at a fixed price over a given period

company a business created as a distinct legal entity composed of one or more individuals or entities

compound interest interest calculated each period on the principal amount and on any interest earned on the investment up to that point

compounding the process of accumulating interest in an investment over time to earn more interest

compound option an option on an option (e.g. an option to buy an option)

conglomerate takeover a takeover of a target company in an unrelated type of business

consol a perpetual bond Also known as a consolidated annuity

consolidation a merger in which an entirely new firm is created and both the acquired and acquiring firm cease to exist

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constant chain of replacement a project is assumed to be replaced at the end of its economic life by an identical project so that projects of unequal lives may be compared

constant dividend growth model model that determines the current price of a share as its dividend next period divided by the discount rate less the dividend growth rate

consumer credit comprises credit extended to individuals by suppliers of goods and services, or by financial institutions through credit cards

contingency planning taking into account the managerial options that are implicit in a project

contingent claim a claim that is not in existence but may come into existence by the happening of some future event

continuous interest a method of calculating interest in which interest is charged so frequently that the time period between each charge approaches zero

conversion ratio the relationship that determines how many ordinary shares will be received in exchange for each convertible or converting security when the conversion occurs

convertible note a note that can be exchanged for a fixed number of shares for a specified amount of time

corporate raiders aggressive corporate or individual investors who purchase a company's shares with the intention of achieving a controlling interest and replacing the existing management

cost of capital the minimum required return on a new investment

cost of debt the return that lenders require on the firm's debt

cost of equity the return that equity investors require on their investment in the firm

cost of stock outs the profits lost because the firm is out of a particular product

coupon payments the stated interest payments made on a bond

coupon rate the annual coupon divided by the face value of a bond

coupons the fixed interest payments made on bonds, debentures and unsecured notes

covenant a provision in a loan agreement to protect lenders' interests by requiring certain actions to be taken or limiting some actions such as increasing the debt

covered interest an arbitrage movement of funds between two currencies to profit from interest rate differences while using forward contracts to eliminate exchange risk

credit analysis the process of determining the probability that customers will or will not pay

credit cost curve graphical representation of the sum of the carrying costs and the opportunity costs of a credit policy

credit instrument the evidence of indebtedness

credit period the length of time that credit is granted

credit policy the seller's policy on whether credit will be offered to customers and on what terms

credit risk the possibility of loss because a party fails to meet its obligations

credit scoring the process of quantifying the probability of default when granting consumer credit

Cross-border lease a finance lease, usually financed through debt, where the lessor and lessee are located in different countries

cross rates exchange rates between two currencies derived from the exchange rates between the currencies and a third currency

cum refers to shares and simply means 'with'

cum dividend the period during which the purchaser of a share is qualified to receive a previously announced dividend The cum dividend period ends on the ex-dividend date

cum rights when shares are traded cum rights, the buyer is entitled to participate in the forthcoming rights issue

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currency swap a simultaneous borrowing and lending operation in which two parties initially exchange specific amounts of two currencies at the spot rate Interest payments in the two currencies are also exchanged and the parties agree to reverse the initial exchange after a fixed term at a fixed exchange rate

current assets cash, inventory, accounts receivable and other assets that will normally be converted into cash within a year

current liabilities debt or other obligations due for payment within a year

D

date of payment date that the dividend cheques are mailed

date of record date on which holders of record are designated to receive a dividend

debentures long-term debt securities Now usually called bonds Sometimes refers specifically to company securities

debenture refunding the process of replacing all or part of an issue of outstanding debentures

debenture trust deed written agreement between the corporation and the lender detailing the terms of the debt issue

debentures or unsecured notes loans made to companies for a fixed period at a fixed rate of interest

debt a financial contract in which the receiver of the initial cash (the borrower) promises a particular cash flow, usually calculated using an interest rate, to the provider of funds (the lender)

debt capacity the ability to borrow to increase firm value

declaration date date on which the board of directors passes a resolution to pay a dividend

default risk the chance that a borrower will fail to meet obligations to pay interest and principal as agreed

deferred annuity an annuity in which the first cash flow is to occur after a time period that exceeds the time period between each subsequent cash flow

deferred call call provision prohibiting the company from redeeming the debt prior to a certain date

degree of operating leverage the percentage change in operating cash flow relative to the percentage change in quantity sold

delinquent accounts accounts where payment has not been made by the due date

depreciation the fall in value of a currency in terms of another currency or currencies It also means the amount an owner should write off an asset as the asset is used and reduces in value

dilution loss in existing shareholders' value, in terms of either ownership, market value, book value, or EPS

direct bankruptcy costs the costs that are directly associated with bankruptcy, such as legal and administrative expenses

direct quote an exchange rate quotation in which the local currency is the quote currency and the foreign currency is the base currency; for example, a direct quote of the Australian dollar might be \$US1 = \$A1.5

discount the amount by which a currency is cheaper for future delivery

discount period the period during which a discount for prompt payment is available to the purchaser discount rate expression of the price reduction a purchaser will receive if payment is made within the discount period The interest rate that reduces a given future value to an equivalent present value

discounter the initial purchaser of a short-term debt security such as a promissory note or a bill of exchange

discount rate the interest rate that reduces a given future value to an equivalent present value

discounted cash flow (DCF) valuation the process of valuing an investment by discounting its future cash flows

discounted payback period the length of time required for an investment's discounted cash flows to equal its initial cost

GLOSSARY

discounting the process by which, through the operation of interest, a future sum is converted to its equivalent present value

distribution payment made by a firm to its owners from sources other than current or accumulated earnings

diversification principle principle stating that spreading an investment across a number of assets will eliminate some, but not all, of the risk

divestiture the sale of a subsidiary, division or collection of related assets, usually to another firm

dividend payment made out of a firm's earnings to its owners, usually in the form of cash

dividend clienteles investors who choose to invest in companies that have dividend policies which meet their particular requirements

dividend drop-off ratio ratio of the decline in the share price on the ex-dividend day to the dividend per share

dividend election schemes arrangements which offer shareholders the option of receiving their dividends in one or more of a number of forms

dividend growth model a model expressing the value of a share as the sum of the present values of future dividends where the dividends are assumed to grow at a constant rate

dividend payout ratio amount of cash paid out to shareholders divided by net profit

dividend reinvestment schemes these offer shareholders the opportunity to apply all or part of their cash dividends to the purchase of newly issued shares, allowing the shareholder to re-invest the dividend without incurring any transaction costs

dividend yield a share's cash dividend divided by its current price

drawer in a bill of exchange, is the party initiating the creation of the bill, usually the borrower

Du Pont identity popular expression breaking ROE into three parts: operating efficiency, asset use efficiency and financial leverage

duration measure of the time period of an outstanding debt

E

economic order quantity the quantity of inventory a firm should order to minimise costs

effective annual interest rate (EAR) the actual rate of interest to be earned or paid

efficient capital market market in which security prices reflect available information

efficient market hypothesis (EMH) the hypothesis that actual capital markets, such as the NYSE or ASX, are efficient

efficient portfolios fully diversified portfolios only have systematic risk

endorsement acceptance by the seller of a bill in the secondary market, of responsibility to pay the face value if there is default by the acceptor, drawer and earlier endorsers

equipment finance a loan or lease used to finance an item of equipment where the equipment is used as security for the finance

equivalent annual value this method involves calculating the annual cash flow of an annuity that has the same life as the project and whose present value equals the net present value of the project

erosion the cash flows of a new project that come at the expense of a firm's existing projects

euro the monetary unit for the European Monetary System (EMS)

Eurobond international bonds issued in multiple countries but denominated in a single currency (usually the issuer's home currency)

Eurocurrency money deposited in a financial centre outside the country whose currency is involved For instance, eurodollars—the most widely used eurocurrency—are US dollars deposited in banks outside the US banking system

GLOSSARY

euromarket an international market for the investment of currencies outside their country of origin and free from government interference

euronote short-term note sold in countries other than the country of the currency in which it is denominated

European option an option that can only be exercised on the expiration date

event study research method that analyses the behaviour of the abnormal returns of a security around the time of a significant event such as the public announcement of the company's earnings

excess volatility a contention that share prices are more variable than they would be if they reflected only the fundamental determinants of their true value

exchange controls government regulations restricting the free exchange of the domestic currency to and from foreign currencies

ex dividend date date seven business days before the date of record, establishing those individuals entitled to a dividend

ex rights period when shares are selling without a recently declared right, normally beginning four business days before the holder-of-record date

exchange rate risk the changes that could occur to cash flows due to changes in exchange rates

exchange rate the price of a currency in terms of another currency

exercise/expiration/declaration date the last day on which an option can be exercised

exercise price the fixed price at which the underlying asset can be traded, subject to the terms of the option contract also known as strike price

exercising the option the act of buying or selling the underlying asset via the option contract

expected return return on a risky asset expected in the future

F

face value the principal amount of a bond that is repaid at the end of the term Also **par value**

factor the provider of finance who buys the accounts receivable, manages the debtors and collects the debts on a continuing basis

factoring the process whereby a firm sells its accounts receivable

factoring with recourse an agreement in which the factor is reimbursed by the selling firm if the debtor defaults

factoring without recourse an agreement in which the factor is not reimbursed by the selling firm if the debtor defaults

finance companies these control about 6 per cent of the total assets of the finance sector in Australia

finance lease a long-term non-cancellable lease that effectively transfers the risks and benefits of ownership of an asset from the lessor to the lessee

financial break-even the sales level that results in a zero NPV

financial contract an arrangement, agreement or investment that produces cash flows

financial distress costs the direct and indirect costs associated with going bankrupt or experiencing financial distress

financial intermediary an institution that acts as a principal in accepting funds from depositors and lending them to borrowers

financial leverage the relationship between debt and personal contributions Financial leverage is measured by ratios such as the debt–equity ratio in relation to companies

financial ratios relationships determined from a firm's financial information and used for comparison purposes

financial risk the equity risk that comes from the financial policy (i.e. capital structure) of the firm

GLOSSARY

financial system consists of individuals, companies, markets and governments that are involved in the process of exchanging financial assets

Fisher effect relationship between nominal returns, real returns and inflation

Fisher's separation theorem in a perfect capital market it is possible to separate the investment decisions of the firm from the consumption decisions of the owners

five Cs of credit the five basic credit factors to be evaluated: character, capacity, capital, collateral and conditions

fixed costs costs that do not change when the quantity of output changes during a particular time period

float the difference between book cash and bank cash, representing the net effect of cheques in the process of clearing

floating charge a mortgage security for debt of a company where the security is all of the assets and not one specific asset such as land

floating rate debt a debt security whose interest rate is adjusted periodically in line with changes in a specified reference rate

floor members members of an exchange who are permitted to be on the trading floor and who can trade on behalf of clients With online computer trading the tradition of being on the floor is no longer relevant Floor-plan finance loan a financial arrangement, usually made by a wholesaler to a retailer, that finances an inventory of durable goods such as motor vehicles Also known as wholesale finance

forecasting risk the possibility that errors in projected cash flows lead to incorrect decisions

foreign bond debt issued outside the borrower's country and denominated in the currency of the country in which it is issued

foreign exchange market the market where one country's currency is traded for another's

forward deal an agreement to exchange currency in the future

forward margin the difference between spot and forward rates

forward rate the exchange rate used for forward transactions It comprises two components: the spot rate plus or minus a forward margin

franked dividends dividends that are paid out of profits on which tax has been levied

franking premium that part of the return on shares or a share market index which is due to tax credits associated with franked dividends

Fully-drawn bill facility a bill facility in which the borrower must issue bills so that the fully-agreed amount is borrowed for the period of the facility

future sum an amount to which a present sum, such as principal, will grow (accumulate) at a future date, through the operation of interest

future value the amount an investment is worth after one or more periods Also compound value

G

general annuity an annuity in which the frequency of charging interest does not match the frequency of payment; thus repayments may be made either more frequently or less frequently than interest is charged

Generally Accepted Accounting Principles (GAAP) the common set of standards and procedures by which audited financial statements are prepared

geometric rate of return the rate of return between two dates, measured by the change in value divided by the earlier value; the average of a sequence of geometric rates of return is found by a process that resembles compounding

gilts these are technically British and Irish government securities; however, they also include issues by local British authorities

GLOSSARY

Global Industry Classification Standard (GICS) a code used globally to classify a firm by its type of business operations

going-private transaction all publicly owned shares in a firm are replaced with complete equity ownership by a private group

H

hard rationing the situation that occurs when a business cannot raise financing for a project under any circumstances

hedge contract a contract, either spot or forward, between $A and $US where settlement is not affected by delivery of the two currencies

hedge ratio the ratio of the change in an option price that results from a change in the price of the underlying asset; also known as an option's delta

hedge settlement rate a spot $US/$A exchange rate calculated by AAP–Reuters at 9.45 a.m. each day based on average spot $US/$A exchange rates

hedgers market participants who enter into contracts in order to reduce risk

holder-of-record date the date on which existing shareholders on company records are designated as the recipients of share rights Also the date of record

home-made dividend idea that individual investors can undo corporate dividend policy by reinvesting dividends or selling shares

home-made leverage the use of personal borrowing to change the overall amount of financial leverage to which the individual is exposed

horizontal takeover a takeover of a target company operating in the same line of business as the acquiring company

I

immunisation a strategy designed to achieve a target sum of money at a future point in time, regardless of interest rate changes

imputation system the imputation system results in individuals receiving a tax credit for the tax actually paid by the company

imputation tax credit credit for Australian company tax paid which, when distributed to shareholders, can be offset against their tax liability

Income Statement financial statement summarising a firm's earnings over a period of time

incremental cash flows the difference between a firm's future cash flows with a project or without the project

independent project one that may be accepted or rejected without affecting the acceptability of another project

indicator rate an interest rate set and published by a lender from time to time and used as a base on which interest rates on individual loans are determined, usually by adding a margin

indifference curve a curve showing a set of combinations such that an individual derives equal utility from (and thus is indifferent between) any combinations in the set

indirect bankruptcy costs the difficulties of running a business that is experiencing financial distress

indirect quotation an exchange rate quotation in which the local currency is the base currency and the foreign currency is the quoted rate; for example, in Australia an indirect quotation is $US0 595 = $A1

information asymmetry cost this arises because investors do not have the same information as management in relation to the prospects of the firm

GLOSSARY

information content effect the market's reaction to a change in corporate dividend payout

information efficiency a situation in which prices accurately reflect available information; different categories of information give rise to different categories of information efficiency

interest on interest interest earned on the reinvestment of previous interest payments

Interest-only loan a loan in which the borrower is required to make regular payments to cover interest accrued but is not required to make payments to reduce the principal. On the maturity date of the loan, the principal is repaid in a lump sum

interest rate the rate of return on debt

interest rate parity (IRP) a theory which states that a forward exchange rate is given by relative interest rates in the two currencies

interest rate swap an agreement between two parties to exchange interest payments for a specific period, related to an agreed principal amount The most common type of interest rate swap involves an exchange of fixed interest payments for floating interest payments

interest tax shield the tax saving attained by a firm from interest expense

internal rate of return (IRR) the discount rate that makes the NPV of an investment zero

intrinsic value the lower bound of an option's value, or what the option would be worth if it were about to expire

inventory could comprise raw materials, work in progress, supplies used in operations or finished goods on hand ready for use

inventory period the time it takes to acquire and sell inventory

investment opportunities opportunities to expand which are expected to be profitable but require further cash outlays to develop or maintain their value

invoice bill for goods or services provided by the seller to the purchaser

invoice discounting an agreement similar to a factoring agreement, in which the selling company retains the sales accounting function

IPOs the initial public offering of securities to the market

issue costs the costs of raising new capital by issuing securities, including underwriting fees and legal, accounting and printing expenses incurred in preparing a prospectus or other offer documents Also known as flotation costs

J

January effect an observation that, on average, share prices increase in January more than in other months

just-in-time (JIT) a system for managing demand-dependent inventories that minimises inventory holdings

L

law of one price principle maintaining that an asset's price in a given currency will be the same regardless of the currency in which the price is quoted

lead time the time it takes from placing an order to the receipt of the inventory

lessee in a lease contract the party using the asset who is equivalent to the borrower

lessor in a lease contract the party that owns the asset and accepts the payments (premiums) from the lessee

leveraged buyout (LBO) going-private transaction in which a large percentage of the money used to buy the shares is borrowed Incumbent management is often involved

leveraged lease a finance lease where the lessor borrows most of the funds to acquire the asset

limited liability a legal concept which protects shareholders whose liability to meet a company's debts is limited to the amount paid on the shares they hold

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liquid assets these comprise cash and assets that are readily convertible into cash, such as bills of exchange and treasury notes

liquidity management this involves decisions about the composition and level of a company's liquid assets

liquidity premium (risk premium) a theory of the term structure of interest rates that although future interest rates are determined by investors' expectations, investors require some reward (liquidity premium) to assume the increased risk of investing long term

log price relative the natural logarithm of the ratio of successive security prices Implicitly, it is assumed that prices have grown (or decayed) in a continuous fashion between the two dates on which the prices are observed Also known as a logarithmic rate of return and a continuous rate of return

London Interbank Offer Rate (LIBOR) a commonly used reference rate, derived daily from the interest rates at which major international banks in London will lend to each other

long hedger a hedger who hedges by means of buying futures contracts now

M

M&M proposition I the value of the firm is independent of its capital structure

M&M proposition II a firm's cost of equity capital is a positive linear function of its capital structure

maintenance lease an operating lease where the lessor is responsible for all maintenance and service of the leased asset

management buyout a purchase of all of the issued shares of a company by a group led by the management

managerial options opportunities that managers can exploit if certain things happen in the future

margin call a demand for extra funds to be deposited into a trader's account because prices have moved against the position of the trader

marginal or incremental cost the change in costs that occurs when there is a small change in output

marginal or incremental revenue the change in revenue that occurs when there is a small change in output

marginal tax rate amount of tax payable on the next dollar earned

market model a time series regression of an asset's returns on the market index; it represents the empirical expression of the capital asset pricing model

market opportunity line a line that shows the combinations of current and future consumption that an individual can achieve from a given wealth level, using capital market transactions

market portfolio a portfolio of all risky assets, weighted according to their market value

market risk premium slope of the SML, the difference between the expected return on a market portfolio and the risk-free rate

market an arrangement whereby participants buy and sell

marking-to-market a process of adjusting traders' account balances to reflect changes in market prices

maturity specified date at which the principal amount of a bond is paid

medium-term notes bearer securities with an initial term to maturity of more than 1 year and issued continually

merchant banks have little direct involvement in the retail banking sector as they are primarily concerned with wholesale banking Have been responsible for the development of cash management trusts, rebatable preference shares, the commercial bills market, the currency hedge market, the promissory note market and the unofficial deposit market

merger the complete absorption of one company by another, where the acquiring firm retains its identity and the acquired firm ceases to exist as a separate entity

money markets financial markets where short-term debt securities are bought and sold

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multiple rates of return one potential problem in using the IRR method if more than one discount rate makes the NPV of an investment zero

mutually exclusive investment decisions one potential problem in using the IRR method if the acceptance of one project excludes that of another

N

net present value (NPV) the difference between an investment's market value and its cost

net present value profile a graphical representation of the relationship between an investment's NPVs and various discount rates

net working capital current assets less current liabilities

nominal interest rate a quoted interest rate where interest is charged more frequently than the basis on which the interest is quoted The interest rate actually used to calculate the interest charge is taken as a proportion of the quoted nominal rate and compounded up to the full period of the nominal rate

nominal return return on an investment not adjusted for inflation

non-bank bill any bill of exchange that has been neither accepted nor endorsed by a bank

non-cash items expenses charged against revenues that do not directly affect cash flow, such as depreciation

non-debt tax shields tax deductions for items such as depreciation, investment tax credits and tax losses carried forward

non-recourse loan a type of loan used in leveraged leases where the lender has no recourse to the lessor in the event of default by the lessee

non-systematic risk a risk that affects at most a small number of assets Also unique or asset-specific risks

normal distribution a symmetric, bell-shaped frequency distribution that can be defined by its mean and standard deviation

note issuance facility a facility provided by one or more institutions that agree to underwrite issues of short-term notes by a borrower

notes unsecured debt securities

O

open account an arrangement under which goods or services are sold to a customer on credit, but with no formal debt contract Payment is due after an account is sent to the customer

operating (or activity) cycle the time period between the acquisition of inventory and when cash is collected from receivables

operating cash flow cash generated from a firm's normal business activities

operating lease a cancellable lease which is written for a period considerably less than the useful life of the leased asset

operating leverage the degree to which a firm or project relies on fixed costs

opportunity cost the most valuable alternative that is given up if a particular investment is undertaken

optimal capital structure the capital structure which maximises the value of a company

option a contract that gives its owner the right to buy or sell some asset at a fixed price on or before a given date

option buyer the taker of an option

option writer the writer of an option is the seller of the option

ordinary annuity an annuity in which the time period from the date of valuation to the date of the first cash flow is equal to the time period between each subsequent cash flow All cash flows occur at the end of the period

GLOSSARY

ordinary perpetuity an ordinary annuity with the special feature that the cash flows are to continue forever

ordinary shares equity without priority for dividends or in bankruptcy regarded asthe risk capital of a company, as such shares have residual and ownership rights

overdraft where the bank permits the customer to draw more money from the bank account than has been put in it

overdraft limit the level to which a firm is permitted to overdraw its account

overnight loan funds lent in the money market on the basis that either party can terminate the loan by 11 a.m. on the following day Also known as 11 a.m. money

overreaction a biased response of a price to information in which the initial price movement can be expected to be reversed

P

P/E ratio the ratio of price to earnings per share

par value (face value) the principal amount of a debenture or note that is repaid at the maturity date

partial takeover a takeover in which a bidder seeks to acquire no more than part of a company's issued shares

partnership a business formed by two or more owners

payback period the amount of time required for an investment to generate cash flows to recover its initial cost

pecking order theory the process of the firm choosing profits, debt and equity in this order to finance investments

percentage of sales approach financial planning method in which accounts are varied depending on a firm's predicted sales level

perfect capital market frictionless market in which there are no taxes, no transaction costs, all relevant information is available at no cost to all participants and all participants are price takers

perpetuity an annuity in which the cash flows continue forever

planning horizon the long-range period that the financial planning process focuses on, usually the next two to five years

poison pill a financial device designed to make unfriendly takeover attempts unappealing, if not impossible

political risk changes in value that arise as a consequence of political actions

portfolio group of assets such as shares and debentures held by an investor

portfolio weight percentage of a portfolio's total value in a particular asset

post-event drift an observation that share returns display a trend after an event

precautionary motive the need to hold cash as a safety margin to act as a financial reserve

preference shares shares with dividend priority over ordinary shares, normally with a fixed dividend rate, sometimes without voting rights

premium the price paid by the buyer to the seller for an option right

present value index (PVI) the present value of an investment's future cash flows divided by its initial cost Also benefit/cost ratio

present value an amount that corresponds to today's value of a promised future sum

present value of a contract the value today that is equivalent to a stream of cash flows promised in a financial contract

price–earnings ratio the share price divided by earnings per share

principal (or principal sum) the amount borrowed at the outset of a debt contract

GLOSSARY

principal-and-interest loans loans repaid by a sequence of equal cash flows, each of which is sufficient to cover the interest accrued since the previous payment and to reduce the current balance owing Therefore, the debt is extinguished when the sequence of cash flows is completed Also known as credit foncier loans

primary market a market where securities are traded for the first time

principle of diversification principle stating that spreading an investment across a number of assets will eliminate some, but not all, of the risk

private issue an issue of securities direct to chosen investors rather than the general public

private placement sale of securities to large institutional investors or selected clients of a sharebroker

private placements loans, usually long-term in nature, provided directly by a limited number of investors

production possibilities curve (frontier) a curve that displays the investment opportunities and outcomes available to the firm; its shape therefore determines the combinations of current dividend, investment and future dividend that the firm can achieve The shape of the curve is driven by the technical efficiency of the firm

profit and loss account financial statement summarising a firm's performance over a period of time

promissory note a short-term marketable debt security in which the borrower promises to pay a stated sum on a stated future date Also known as one-name paper and commercial paper

proportional bid a partial takeover bid to acquire a specified proportion of the shares held by each shareholder

prospectus the document required by law to be issued with share offers to the public

protective covenant part of the trust deed limiting certain transactions that can be taken during the term of the loan, usually to protect the lender's interest

proxy contest attempt to gain control of a firm by soliciting a sufficient number of shareholder votes to replace existing management

purchasing power parity (PPP) a theory which states that the exchange rate between two currencies adjusts to reflect the relative inflation rates in the two currencies

pure play approach use of a WACC that is unique to a particular project

put–call parity a relationship that exists between the price of a call option and the price of the corresponding put option

put option the right to sell an asset at a fixed price during a particular period The opposite of a call option

put option on a futures contract an option that gives the buyer the right to enter into the futures contract as a seller at a predetermined price

R

random-walk hypothesis a theory that the time sequence of returns on shares conforms to the statistical concept of a 'random walk'; this includes the implication that the time sequence is random

real interest the interest rate after taking out the effects of inflation

real returns returns adjusted for the effects of inflation

rediscounting selling a short-term debt security in the secondary market

registered form registrar of company records ownership of each note; payment is made directly to the owner of record

regular cash dividend cash payment made by a firm to its owners in the normal course of business, usually made twice a year (interim and final)

residual claim the claim to profit or assets that remains after the entitlements of all other interested parties have been met

GLOSSARY

residual dividend approach policy where a firm pays dividends only after meeting its investment needs while maintaining a desired debt-to-equity ratio

residual value the final value in a leasing contract that must be paid by the lessee on completion of the contract

retained earnings corporate earnings not paid out as dividends

retention ratio retained earnings divided by net profit Also called the ploughback ratio

reverse split procedure where a firm's number of shares outstanding is reduced

revolving credit bill facility a facility in which the borrower can issue bills as required, up to the agreed limit

risk-averse investor one who dislikes risk

risk-neutral investor one who neither likes nor dislikes risk

risk neutrality a situation in which investors are indifferent to risk; assets are therefore priced such that they are expected to yield the risk free interest rate

risk premium the excess return required from an investment in a risky asset over a risk-free investment

risk-seeking investor one who prefers risk

S

safety stock additional inventory held when demand is uncertain, to reduce the probability of a stockout sale and lease-back agreement an agreement in which a company sells an asset and then leases it back from the buyer

scenario analysis the determination of what happens to NPV estimates when we ask 'what if' questions

secondary market a market where subsequent trading of securities occurs

secondary market transaction the purchase or sale of an existing security

securitisation a process whereby mortgages are pooled, insured and shares in the pool sold

security market line (SML) positively sloped straight line displaying the relationship between expected return and beta

semi-strong-form efficiency where all publicly available information is reflected in the security's current market price

sensitivity analysis investigation of what happens to NPV when only one variable is changed

settlement procedures institutional arrangements for the payment and receipt of funds after a transaction

share rights plan (SRP) provisions allowing existing shareholders to purchase shares at some fixed price should an outside takeover bid take place, discouraging hostile takeover attempts

share split an increase in a firm's shares outstanding without any change in owners' equity

shareholders owners of equity in a corporation

shortage costs costs that fall with increases in the level of investment in current assets

short hedger a hedger who hedges by means of selling futures contracts today

short selling the process of first entering into a contract to sell and later entering into a contract to buy It is the process of selling something that is not already owned

short-term financial decisions these decisions typically involve cash inflows and outflows that occur within a year or less

simple interest the method of calculating interest in which, during the entire term of the loan, interest is computed on the original sum borrowed

simulation analysis a combination of scenario and sensitivity analyses

sinking fund account managed by the debenture trustee for early debenture redemption

GLOSSARY

size effect an observation that returns on the shares of small capitalisation companies appear to be too high compared to returns on other shares

soft rationing the situation that occurs when units in a business are allocated a certain amount of financing for capital budgeting

sole proprietorship a business owned by a single individual

sources of cash a firm's activities that generate cash

speculative motive the need to hold cash to take advantage of additional investment opportunities, such as bargain purchases

speculators market participants who enter into contracts in order to profit from correctly anticipating price movements

spot deal an agreement to exchange currency within two days

spot price the price of the commodity when the buyer pays immediately and the seller delivers immediately

spot rate the rate for transactions for immediate delivery In the case of foreign exchange, the spot rate is for settlement in two days

spread a long (bought) position in one maturity date, paired with a short (sold) position in another maturity date

stakeholder someone other than a shareholder or debtholder who potentially has a claim on a firm

stand-alone principle evaluation of a project based on the project's incremental cash flows

standard deviation the positive square root of the variance

stated or nominal interest rate a quoted interest rate where interest is charged more frequently than the basis on which the interest is quoted The interest rate actually used to calculate the interest charge is taken as a proportion of the quoted nominal rate and compounded up to the full period of the nominal rate

static theory of capital structure theory that a firm borrows up to the point where the tax benefit from an extra dollar in debt is exactly equal to the cost that comes from the increased probability of financial distress

strategic options options for future, related business products or strategies

striking price the fixed price in the option contract at which the holder can buy or sell the underlying asset Also the exercise price or strike price

strong-form efficiency all information, whether public or private, is reflected in the security's current market price

subordinated debt debt which ranks below other debt in the event that a company is wound up subscription price the price that must be paid to obtain a new share

sub-underwriters a group of underwriters formed to reduce the risk and help to sell an issue

sunk cost a cost that has already been incurred and cannot be removed and therefore should not be considered in an investment decision

superannuation industry the growth area where 98 per cent of the funds are self-managed with fewer than five members

sustainable growth rate the growth rate a firm can maintain given its debt capacity, ROE, and retention ratio

swaps agreements to the exchange of two securities or currencies

syndicated loan a loan arranged by one or more leading banks which is funded by a syndicate that usually includes other banks

synergy the positive incremental net gain associated with the combination of two firms through a merger or acquisition

synergy in takeovers the situation where the performance and therefore the value of a combined entity exceed those of the previously separate components

GLOSSARY

systematic risk principle principle stating that the expected return on a risky asset depends only on that asset's systematic risk
systematic risk a risk that influences a large number of assets Also market risk
systematic risk cannot be avoided or reduced
systematic risk is covariance risk

T

takeover an acquisition of control of one company by another
target cash balance a firm's desired cash level as determined by the trade-off between carrying costs and shortage costs
target company the object of a takeover bid
target determinant the amount by which funds are transferred between investments and the bank account to maintain the target cash balance no definition yet
target payout ratio a firm's long-term desired dividend-to-earnings ratio
tax loss selling an investment strategy in which the tax rules make it attractive for an investor to sell certain shares just before the end of the tax year to take advantage of accumulated losses
tender offer a public offer by one firm to directly buy the shares of another firm
term loan an advance of funds made by a bank for a fixed period and a specific purpose
term structure of interest rates the relationship between interest rates and term to maturity for debt securities in the same risk class
terminal value of a contract the value as at the date of the final cash flow
terms of sale conditions on which a firm sells its goods and services for cash or credit
theoretical ex-rights share price the expected price of one share when shares begin to be traded ex-rights
theoretical rights price the expected price of one right calculated on the basis of the cum rights share price
thin-trading problem because some shares trade relatively infrequently, a current market price at a given time may be unavailable, thus causing difficulties in statistical testing
time value the value of an option in excess of its intrinsic value
time value of money the fundamental principle of finance that individuals prefer to receive a dollar today rather than a dollar in the future
tombstone an advertisement announcing completion of a public offering
trade credit an arrangement in which a seller of goods or services allows the purchaser a period of time before requiring payment; it is equivalent to a short-term loan made by the seller to the purchaser, of an amount equal to the purchase price
trade-off theory a theory which proposes that companies have an optimal capital structure based on a trade-off between the benefits (tax) and costs (bankruptcy) of using debt
trading banks these account for about 40 per cent of the total assets of the finance sector in Australia
trading range price range between highest and lowest prices at which a stock is traded
transaction motive the need to hold cash to satisfy normal disbursement and collection activities associated with a firm's ongoing operations
treasury stock a U.S. term for a company's own shares that have been repurchased and held rather than cancelled
turn-of-the-month effect an observation that, on average, share prices increase around the time of a new month beginning, more than at other times

GLOSSARY

U

unbiased forward rates (UFR) a theory which states that the forward rate is an unbiased predictor of the future spot rate

uncovered interest parity (UIP) a theory which states that the difference in interest rates between two countries is an unbiased predictor of the future change in the spot exchange rate Also called the international Fisher effect

underreaction a biased response of a price to information in which the initial price movement can be expected to continue

underwriters investment firms that act as intermediaries between a company selling securities and the investing public

unlevered cost of capital the cost of capital of a firm that has no debt

unlisted market trading this trading is confined to bargaining by individual buyers and sellers and around $3 billion is invested in the unlisted equity market

unsubordinated debt the debt which has not been subordinated

unsystematic (diversifiable) risk that component of total risk which is unique to the firm and may be eliminated by diversification

uses of cash the activities of a firm in which cash is spent Also applications of cash

V

variable costs costs that change when the quantity of output changes

variable interest rate loan a loan where the lender can change the interest rate charged, usually in line with movements in the general level of interest rates in the economy

variance the average squared deviation between the actual return and the average return

vertical takeover a takeover of a target company which is either a supplier of goods to, or a consumer of goods produced by, the acquiring company

W

weak-form efficiency the information contained in the past series of prices of a security is reflected in the security's current market price

weighted average cost of capital (WACC) the weighted average of the costs of debt and equity

wholesale banking involves transactions with companies or businesses

winner's curse the problem that arises in bidding because the bidder who 'wins' is likely to be the one who most overestimates the value of the assets offered for sale

withholding tax the tax deducted by a company from the dividend payable to a non-resident shareholder

Y

yield curve a graph of yield to maturity against bond term at a given point in time

yield to maturity the market interest rate that equates a bond's present value of interest payments and principal repayments with its price

Z

zero coupon debenture a debenture that makes no coupon payments, thus initially priced at a deep discount