**Financial Management**

**Glossary**

**Chapter 1**

**The Role of Managerial Manager & the Financial Market Analysis**

* **Financial management** is generally defined as those activities that create or preserve the economic value of the assets of an individual, small business, or corporation.
* **Sole proprietorship**:The simplest and most common form of business ownership, sole proprietorship is a business owned and run by someone for their own benefit. The business’ existence is entirely dependent on the owner’s decisions, so when the owner dies, so does the business.
* **Partnership:** These come in two types: general and limited. In general partnerships, both owners invest their money, property, labor, etc. to the business and are both 100% liable for business debts. In other words, even if you invest a little into a general partnership, you are still potentially responsible for all its debt. General partnerships do not require a formal agreement—partnerships can be verbal or even implied between the two business owners.
* **Corporations** are, for tax purposes, separate entities and are considered a legal person. This means, among other things, that the profits generated by a corporation are taxed as the “personal income” of the company. Then, any income distributed to the shareholders as dividends or profits are taxed again as the personal income of the owners.
* **Financial Planning decisions** which relate to estimating the sources and application of funds. It means pre-estimating financial needs of an organization to ensure the availability of adequate finance. The primary objective of financial planning is to plan and ensure that the funds are available as and when required.
* **Capital Structure decisions** which involve identifying sources of funds. They also involve decisions with respect to choosing external sources like issuing shares, bonds, borrowing from banks or internal sources like retained earnings for raising funds.
* **Dividend Decisions:**These involve decisions related to the portion of profits that will be distributed as dividend. Shareholders always demand a higher dividend, while the management would want to retain profits for business needs. Hence, this is a complex managerial decision.
* **Comparisons** Figures and reports should be expressed in terms of standards of performance. Financial executives often take initiative decisions based upon their personal judgments. These decisions are subjective. If standards of performance, including those of past performance, are expressed, the subjective element, which is likely to creep into a financial plan, can be eliminated.
* **Flexibility** The financial plan should be such that it can be made flexible so that it can be modified or changed, if it is necessary to do so. Making provisions for valuable or convertible securities can do this. It would be better to avoid restrictive or binding provisions in debentures and preferred stock. A flexible sinking fund position may be introduced in debenture financing. The environment of a firm may change from time to time. It is therefore advisable to have a more versatile plan than a routine one.
* **Profitability:** A financial plan should maintain the required proportion between fixed charge obligations and liabilities in such a manner that the profitability of the organization is not adversely affected. The most crucial factor in financial planning is the forecasting of sales, for sales almost invariably represent the primary source of income and cash receipts. Besides, the operation of the business is geared to the anticipated volume of sales. The management should recognize the likely margins of error inherent in forecasts, and this recognition would enable the management to avoid the hazards involved in attaching a false accuracy to forecast data based on tenuous assumptions.
* **Maneuverability:** Maneuverability is the direct result of a management’s adherence to the financial structure which is acceptable to the business community; that is creditors, shareholders, bankers, etc.It is necessary to choose a financial plan, which may control the crisis, the crisis that may develop from time to time. It is well known that any financial plan should aim at a proper balance between debt and equity. This is essential to ensure that the stake of the entrepreneur in an industry or concern is substantial, so that his handling of the affairs, finances and others may be in its best interest.
* **Risks:** There are different types of risks but the financial manager is more concerned about the financial risk which is created by a high debt-equity ratio than about any other risk. If earnings are high, the financial risk may not have much of an impact. In other words if the economic risks of the business activities are reduced to minimum, a firm may not be exposed to financial risks. Its refinancing should be planned in such a manner that the impact of risk is not seriously felt.

**Chapter 2**

**CVP Analysis**

**Break-even chart:** a graph that depicts the relationships among revenue, volume, variable costs, fixed costs, and profits (or losses)

**Break-even point** **(BEP):** the level of activity, in units or dollars, at which total revenues equal total costs

**Contribution margin:** the difference between selling price and variable cost per unit or in total for the level of activity; it indicates the amount of each revenue dollar remaining after variable costs have been covered that is available to cover fixed costs and profits

**Contribution margin ratio:** the proportion of each revenue dollar remaining after variable costs have been covered; computed as contribution margin divided by revenue

**Cost-volume-profit** **(CVP)** **analysis:** a procedure that examines changes in costs and volume levels and the resulting effects on net income (profits)

**Degree of operating leverage:** a factor that indicates how a percentage change in sales, from the existing or current level, will affect company profits; it is calculated as contribution margin divided by net income or (1 ¡Â margin of safety percentage)

**Incremental analysis:** a process of evaluating alternatives that focuses only on the factors that differ from one course of action or decision to another

**Margin of safety:** the excess of the budgeted or actual sales of a company over its break-even point; it can be calculated in units or dollars or as a percentage; it is equal to (1 ¡Â degree of operating leverage)

**Operating leverage:** the proportionate relationship between a company¡¯s variable and fixed costs

**Profit-volume** **graph:** a visual representation of the amount of profit or loss associated with each level of sales

**Variable cost ratio:** the proportion of each revenue dollar needed to cover variable costs; computed as variable costs divided by sales or as (1 ¨C contribution margin ratio**Cost Behavior Analysis**

Cost behavior analysis is the study of how specific costs respond to changes in the level of business activity.

**Variable Costs**

Variable costs are costs that vary in total directly and proportionately with changes in the activity level or cost that remains the same per unit at every level of activity. Examples of variable costs include direct materials and direct labor for a manufacturer; cost of goods sold, sales commissions, and freight-out for a merchandiser; and gasoline in airline and trucking companies.

**Fixed Costs**

Fixed costs are costs that remain the same in total regardless of changes in the activity level.  
  
Examples include property taxes, insurance, rent, supervisory salaries, and depreciation on buildings and equipment. Because total fixed costs remain constant as activity changes, it follows that fixed costs per unit vary inversely with activity: As volume increases, unit cost declines, and vice versa.

**Cost-volume-profit (CVP)**

Cost-volume-profit (CVP) analysis is the study of the effects of changes in costs and volume on a company's profits.

**CVP Assumptions**

The following assumptions underlie each CVP analysis.  
  
-The behavior of both costs and revenues is linear throughout the relevant range of the activity index.  
-Costs can be classified accurately as either variable or fixed.  
-Changes in activity are the only factors that affect costs.  
-All units produced are sold.  
-When more than one type of product is sold, the sales mix will remain constant. That is, the percentage that each product represents of total sales will stay the same.

**Chapter 3**

**Long term Finance**

* **Long-term financing** means financing by loan or borrowing for more than one year by issuing equity shares, a form of debt financing, long-term loans, leases, or bonds. It is usually done for big projects, financing, and company expansion. Such long-term financing is generally of high amount
* **Common stock** is a security that represents ownership in a corporation. Holders of common stock elect the [board of directors](https://www.investopedia.com/terms/b/boardoftrustees.asp) and vote on corporate policies. This form of equity ownership typically yields higher rates of return long term. However, in the event of [liquidation](https://www.investopedia.com/terms/l/liquidation.asp), common shareholders have rights to a company's assets only after bondholders, preferred shareholders, and other debtholders are paid in full.
* **Preferred stock** is a type of stock that offers different rights to shareholders than [common stock](https://www.bankrate.com/glossary/c/common-stock/). Preferred stock holders receive regular [dividends](https://www.bankrate.com/glossary/d/dividend/) and are repaid first in the event of a [bankruptcy](https://www.bankrate.com/personal-finance/debt/bankruptcy/) or merger. Companies typically issue more common shares than preferred ones, which are generally prized by investors looking for a steady income.
* **Debt capital** is the capital that a business raises by taking out a [loan](https://en.wikipedia.org/wiki/Loan). It is a loan made to a company, typically as [growth capital](https://en.wikipedia.org/wiki/Growth_capital), and is normally repaid at some future date. Debt capital differs[[1]](https://en.wikipedia.org/wiki/Debt_capital#cite_note-1) from [equity](https://en.wikipedia.org/wiki/Stock) or [share capital](https://en.wikipedia.org/wiki/Share_capital) because subscribers to debt capital do not become part owners of the business, but are merely [creditors](https://en.wikipedia.org/wiki/Creditor), and the suppliers of debt capital usually receive a contractually fixed annual percentage return on their loan, and this is known as the [coupon rate](https://en.wikipedia.org/wiki/Coupon_rate). However, sometimes the loan is paid back based on a percentage of the company's monthly revenue instead of a fixed interest rate, such as the case with [revenue-based financing](https://en.wikipedia.org/wiki/Revenue-based_financing).
* **Corporate finance** is the subfield of [finance](https://www.investopedia.com/ask/answers/what-is-finance/) that deals with how corporations address funding sources, capital structuring, accounting, and investment decisions
* **Personal finance** is a term that covers managing your money as well as [saving and investing](https://www.investopedia.com/articles/investing/022516/saving-vs-investing-understanding-key-differences.asp). It encompasses budgeting, banking, insurance, mortgages, investments, [retirement planning](https://www.investopedia.com/terms/r/retirement-planning.asp), and tax and estate planning.
* **Behavioral finance**, a subfield of [behavioral economics](https://www.investopedia.com/terms/b/behavioraleconomics.asp), proposes that psychological influences and biases affect the financial behaviors of investors and financial practitioners.
* **Common stock** is a security that represents ownership in a corporation. Holders of common stock elect the [board of directors](https://www.investopedia.com/terms/b/boardoftrustees.asp) and vote on corporate policies.
* **Preference shares**, more commonly referred to as [preferred stock](https://www.investopedia.com/terms/p/preferredstock.asp), are shares of a company’s stock with dividends that are paid out to shareholders before common stock dividends are issued
* **Dividend** is the distribution of a company's earnings to its shareholders and is determined by the company's [board of directors](https://www.investopedia.com/terms/b/boardofdirectors.asp). Dividends are often distributed quarterly and may be paid out as cash or in the form of reinvestment in [additional stock](https://www.investopedia.com/terms/s/stockdividend.asp).

**Chapter 4**

**Financial Statement Analysis**

1. **Liquidity Ratios:** Liquidity measure a company's ability to pay off its short-term debts as they become due, using the company's current or quick assets. Liquidity ratios include the current ratio, quick ratio, and working capital ratio.
2. **Solvency Ratios:** Also called financial leverage ratios, [**solvency ratios**](https://www.investopedia.com/terms/s/solvencyratio.asp) compare a company's debt levels with its assets, equity, and earnings, to evaluate the likelihood of a company staying afloat over the long haul, by paying off its long-term debt as well as the interest on its debt. Examples of solvency ratios include: debt-equity ratios, debt-assets ratios, and interest coverage ratios.
3. **Profitability Ratios:** These ratios convey how well a company can generate profits from its operations. Profit margin, return on assets, return on equity, return on capital employed, and gross margin ratios are all examples of[profitability ratios](https://www.investopedia.com/terms/p/profitabilityratios.asp).
4. **Efficiency Ratios:** Also called activity ratios, [**efficiency ratios**](https://www.investopedia.com/terms/e/efficiencyratio.asp) evaluate how efficiently a company uses its assets and liabilities to generate sales and maximize profits. Key efficiency ratios include: turnover ratio, inventory turnover, and days' sales in inventory.
5. **Coverage Ratios:** [Coverage ratios](https://www.investopedia.com/terms/c/coverageratio.asp)measure a company's ability to make the interest payments and other obligations associated with its debts. Examples include the [times interest earned ratio](https://www.investopedia.com/terms/t/tie.asp) and the [debt-service coverage ratio](https://www.investopedia.com/terms/d/dscr.asp).\
6. **Market Prospect Ratios**: These are the most commonly used ratios in fundamental analysis. They include [dividend yield](https://www.investopedia.com/terms/d/dividendyield.asp), [P/E ratio](https://www.investopedia.com/terms/p/price-earningsratio.asp), [earnings per share](https://www.investopedia.com/terms/e/eps.asp) (EPS), and [dividend payout ratio](https://www.investopedia.com/terms/d/dividendpayoutratio.asp). Investors use these metrics to predict earnings and future performance.
7. **The Current Ratio:** The [current ratio](https://www.investopedia.com/terms/c/currentratio.asp) measures a company's ability to pay off its current liabilities (payable within one year) with its total [current assets](https://www.investopedia.com/terms/c/currentassets.asp) such as cash, [accounts receivable](https://www.investopedia.com/terms/a/accountsreceivable.asp), and [inventories](https://www.investopedia.com/terms/i/inventory.asp). The higher the ratio, the better the company's liquidity position
8. **The Quick Ratio:** The [quick ratio](https://www.investopedia.com/terms/q/quickratio.asp) measures a company's ability to meet its short-term obligations with its most liquid assets and therefore excludes inventories from its current assets. It is also known as the [acid-test](https://www.investopedia.com/terms/a/acidtest.asp) ratio:
9. The interest coverage ratio measures how many times a company can cover its current interest payments with its available [earnings](https://www.investopedia.com/terms/e/earnings.asp). In other words, it measures the margin of safety a company has for paying interest on its debt during a given period.
10. The **debt-to-assets ratio** measures a company's total debt to its total [assets](https://www.investopedia.com/terms/a/asset.asp). It measures a company's leverage and indicates how much of the company is funded by debt versus assets, and therefore, its ability to pay off its debt with its available assets. A higher ratio, especially above 1.0, indicates that a company is significantly funded by debt and may have difficulty meetings its obligations.
11. **The equity ratio**, or equity-to-assets, shows how much of a company is funded by [equity](https://www.investopedia.com/terms/e/equity.asp) as opposed to debt. The higher the number, the healthier a company is. The lower the number, the more debt a company has on its books relative to equity.
12. **The D/E ratio** is similar to the debt-to-assets ratio, in that it indicates how a company is funded, in this case, by debt. The higher the ratio, the more debt a company has on its books, meaning the likelihood of default is higher. The ratio looks at how much of the debt can be covered by equity if the company needed to liquidate.
13. **Return on Assets (ROA)**:Profitability is assessed relative to costs and expenses and analyzed in comparison to [assets](https://www.investopedia.com/terms/a/asset.asp) to see how effective a company is deploying assets to generate sales and profits. The use of the term "return" in the ROA measure customarily refers to net profit or [net income](https://www.investopedia.com/terms/n/netincome.asp)—the value of earnings from sales after all costs, expenses, and taxes. ROA is net income divided by total assets.
14. **Return on Equity (ROE):ROE** is a key ratio for [shareholders](https://www.investopedia.com/terms/s/shareholder.asp) as it measures a company's ability to earn a return on its equity investments. ROE, calculated as net income divided by shareholders' equity, may increase without additional equity investments. The ratio can rise due to higher net income being generated from a larger [asset base](https://www.investopedia.com/terms/a/asset-base.asp) funded with debt.

**Chapter 5**

**Capital Budgeting**

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| --- | --- | --- |
| Replacement Decision | a | A. The decision rule for the capital budgeting method states a project should be considered acceptable, if the difference between its discounted cash inflows and cost is positive. |
| Net Present value | b | This analytical technique is less reliable for identifying acceptable projects as it ignores the time value of money. |
| NPV profile | c | A curve showing the relationship between a project's net present value and various discounts rate. |
| Post-Audit analysis | d | This capital budgeting technique calculate a discount rate that should be compared to a firm's cost capital to determine whether a capital project should be accepted or rejected. |
| Internal rate of return | e | This analysis conducted following the implementation of an accepted capital project and is intended to improve a firm's forecasting process and to improve the firm's operations. |
| Capital budgeting | f | A term used to describe a firm's cost of capital;this value is used as the hurdle against which a project's internal rate of return is compared to ascertain whether a project is acceptable. |
| Independent project | g | A capital budgeting analysis that determines a capital asset should be purchased to take the place of a worn out, damaged, or obsolete existing asset. |
| Payback Period | h | This discount rate at which the present value of a project's cash outflows is equal to the present value of the sum of its future cash inflows, assuming that cash flows are reinvested at the firm's required rate of return. |
| Required rate of return | i | Capital projects who cash flows are not affected by the acceptance or rejection decisions made regarding other projects. |
| Modified internal rate of return | j | The process of planning and evaluating expenditures on asset whose cash flows expected to extend beyond one year. |

**Answer and Explanation:**

|  |  |  |
| --- | --- | --- |
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| Modified internal rate of return | f | A term used to describe a firm's cost of capital;this value is used as the hurdle against which a project's internal rate of return is compared to ascertain whether a project is acceptable. |

**Chapter 6**

**Capital Structure**

* **Capital structure:** the makeup of the capitalization of a business in terms of the amounts and kinds of equity and debt securities: the equity and debt securities of a business together with its surplus and reserves.
* **Net Income Approach:** is a way of finding a value on multi-unit properties by looking at th**e** property's ability to generate cash flow and profit
* **Net Operating Income Approach:** Durand also provides this approach. It is the opposite of the Net Income Approach if there are no taxes. This approach says that the weighted average cost of capital remains constant. It believes in the fact that the market analyses a firm as a whole and discounts at a particular rate that has no relation to the debt-equity ratio. If tax information is given, it recommends that WACC reduces with an increase in debt financing, and the firm’s value will start increasing
* **Traditional Approach**: This approach does not define hard and fast facts, and it says that the cost of capital is a function of the capital structure. The unique thing about this approach is that it believes in an optimal capital structure. Optimal capital structure implies that the cost of capital is minimum at a particular ratio of [debt and equity](https://efinancemanagement.com/financial-leverage/debt-vs-equity), and the firm’s value is maximum.
* **Modigliani and Miller Approach (MM Approach):** It is a capital structure theory named after Franco Modigliani and Merton Miller. MM theory proposed two propositions.

Proposition I: It says that the capital structure is irrelevant to the value of a firm. The value of two identical firms would remain the same, and value would not affect the choice of finance adopted to finance the assets. The value of a firm is dependent on the expected future earnings. It is when there are no taxes.

Proposition II: It says that the financial leverage boosts the value of a firm and reduces WACC. It is when tax information is available.

* The **trade-off theory of capital structure** is the idea that a company chooses how much debt finance and how much equity finance to use by balancing the costs and benefits. The classical version of the hypothesis goes back to Kraus and Litzenberger who considered a balance between the dead-weight costs of bankruptcy and the tax saving benefits of debt. Often [agency costs](https://en.wikipedia.org/wiki/Agency_costs) are also included in the balance. This theory is often set up as a competitor theory to the [pecking order theory of capital structure](https://en.wikipedia.org/wiki/Pecking_order_theory_of_capital_structure) A review of the trade-off theory and its supporting evidence is provided by Ai, Frank, and Sanati.
* **The Pecking Order Theory**: also known as the Pecking Order Model, relates to a company’s [capital structure](https://corporatefinanceinstitute.com/resources/knowledge/finance/capital-structure-overview/). Made popular by Stewart Myers and Nicolas Majluf in 1984, the theory states that managers follow a hierarchy when considering sources of financing.

**Chapter 7**

**Working Capital management**

* **Working capital management** is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to their most effective use.
* **Current assets** represent all the [assets](https://www.investopedia.com/terms/a/asset.asp) of a company that are expected to be conveniently sold, consumed, used, or exhausted through standard business operations with one year. Current assets appear on a company's [balance sheet](https://www.investopedia.com/terms/b/balancesheet.asp), one of the required [financial statements](https://www.investopedia.com/terms/f/financial-statements.asp) that must be completed each year.
* **Cash** is [legal tender](https://www.investopedia.com/terms/l/legal-tender.asp)—currency or coins—that can be used to exchange goods, debt, or services. Sometimes it also includes the value of assets that can be easily converted into cash immediately, as reported by a company.
* **Accounts receivable (AR)** is the balance of money due to a firm for goods or services delivered or used but not yet paid for by customers. Accounts receivables are listed on the balance sheet as a current asset. AR is any amount of money owed by customers for purchases made on credit
* A **liquid asset** is an asset that can easily be converted into cash in a short amount of time. Liquid assets include things like cash, [money market](https://www.investopedia.com/terms/m/moneymarket.asp) instruments, and marketable securities. Both individuals and businesses can be concerned with tracking liquid assets as a portion of their net worth. For the purposes of financial accounting, a company’s liquid assets are reported on its balance sheet as current assets.
* **The cash conversion cycle (CCC)** is a metric that expresses the time (measured in days) it takes for a company to convert its investments in inventory and other resources into cash flows from sales. Also called the Net Operating Cycle or simply Cash Cycle, CCC attempts to measure how long each net input dollar is tied up in the production and sales process before it gets converted into cash received
* **Inventory management** To operate with maximum efficiency and maintain a comfortably high level of working capital, a company must [keep sufficient inventory on hand](https://www.investopedia.com/terms/i/inventory-management.asp) to meet customers' needs while avoiding unnecessary inventory that ties up working capital.
* **Current liabilities** are a company's short-term financial obligations that are due within one year or within a normal operating cycle. An operating cycle, also referred to as the [cash conversion cycle](https://www.investopedia.com/terms/c/cashconversioncycle.asp), is the time it takes a company to purchase inventory and convert it to cash from sales. An example of a current liability is money owed to suppliers in the form of [accounts payable](https://www.investopedia.com/terms/a/accountspayable.asp).
* "**Accounts payable" (AP**) refers to an account within the [general ledger](https://www.investopedia.com/terms/g/generalledger.asp) that represents a company's obligation to pay off a short-term debt to its creditors or suppliers. Another common usage of "AP" refers to the business department or division that is responsible for making payments owed by the company to suppliers and other creditors.

**Chapter 8**

**Risk & Return**

1. **Risk** is defined in financial terms as the chance that an outcome or investment's actual gains will differ from an expected outcome or [return](https://www.investopedia.com/terms/r/roys-safety-first-criterion.asp). Risk includes the possibility of losing some or all of an original investment.
2. **Uncertainty** refers to [epistemic](https://en.wikipedia.org/wiki/Epistemology) situations involving imperfect or unknown [information](https://en.wikipedia.org/wiki/Information). It applies to predictions of future events, to physical measurements that are already made, or to the unknown
3. **Systemic risk** is the possibility that an event at the company level could trigger severe instability or collapse an entire industry or economy.
4. **Unsystematic risk** is the risk that is unique to a specific company or industry. It's also known as nonsystematic risk, [specific risk](https://www.investopedia.com/terms/s/specificrisk.asp), diversifiable risk, or residual risk. In the context of an investment portfolio, unsystematic risk can be reduced through diversification—while [systematic risk](https://www.investopedia.com/video/play/systematic-risk/) is the risk that's inherent in the market.
5. **Return:** A return, also known as a financial return, in its simplest terms, is the money made or lost on an investment over some period of time. A return can be expressed nominally as the change in dollar value of an investment over time
6. **Inflation** is a rise in prices, which can be translated as the decline of [purchasing power](https://www.investopedia.com/terms/p/purchasingpower.asp) over time. The rate at which purchasing power drops can be reflected in the average price increase of a [basket of selected goods](https://www.investopedia.com/terms/b/basket_of_goods.asp) and services over some period of time. The rise in prices, which is often expressed as a percentage, means that a unit of currency effectively buys less than it did in prior periods. Inflation can be contrasted with [deflation](https://www.investopedia.com/terms/d/deflation.asp), which occurs when prices decline and purchasing power increases.
7. **Deflation** is a general decline in prices for goods and services, typically associated with a contraction in the supply of money and credit in the economy. During deflation, the purchasing power of currency rises over time.
8. **Standard deviation** is a statistic that measures the dispersion of a dataset relative to its [mean](https://www.investopedia.com/terms/m/mean.asp) and is calculated as the square root of the [variance](https://www.investopedia.com/terms/v/variance.asp). The standard deviation is [calculated](https://www.investopedia.com/ask/answers/021115/what-difference-between-standard-deviation-and-z-score.asp) as the square root of variance by determining each data point's deviation relative to the mean.
9. **Investment Risk :**Financial exposure is the amount an investor stands to lose in [investment](https://www.investopedia.com/articles/basics/11/3-s-simple-investing.asp) should the investment fail. For example, the financial exposure involved in purchasing a car would be the initial investment amount minus the insured portion. Knowing and understanding financial exposure, which is an alternative name for [risk](https://www.investopedia.com/ask/answers/041415/what-are-some-common-measures-risk-used-risk-management.asp), is a crucial part of the investment process.
10. **Business Risk** : in a nutshell, business risk is the exposure a company has to various factors like competition, consumer preferences and other metrics that might lower profits or endanger the company's success. When entering a market, every company is exposed to business risk in that there are various factors that may negatively impact profits and might even lead to the business' demise - including things like government regulations or the overall economy.
11. **Market risk** is a broad term that encompasses the risk that investments or equities will decline in value due to larger economic or market changes or events.
12. [**Exchange rate**](https://www.investopedia.com/terms/e/exchangerate.asp) risk, or [foreign exchange (forex)](https://www.investopedia.com/terms/f/foreignexchangerisk.asp) risk, is an unavoidable risk of foreign investment, but it can be mitigated considerably through hedging techniques. To eliminate forex risk, an investor would have to avoid investing in overseas assets altogether. However, exchange rate risk can be mitigated with currency forwards or futures.
13. **Liquidity risk** is involved when assets or securities cannot be liquidated (that is, turned into cash) fast enough to ride out an especially volatile market. This kind of risk affects businesses, corporations or individuals in their ability to pay off debts without suffering losses.

**Chapter 9**

**Cost of Capital**

1. **Cost of capital** is a company's calculation of the minimum return that would be necessary in order to justify undertaking a [capital budgeting](https://www.investopedia.com/terms/c/capitalbudgeting.asp) project, such as building a new factory.
2. **Weighted average cost of capital (WACC)** represents a firm's average [cost of capital](https://www.investopedia.com/terms/c/costofcapital.asp) from all sources, including common stock, preferred stock, bonds, and other forms of debt.
3. **Net present value (NPV)** is the difference between the present value of cash inflows and the present [value](https://www.investopedia.com/terms/v/valuation.asp) of cash outflows over a period of time.
4. **Cost of equity** is the return that a company requires to decide if an investment meets capital return requirements. Firms often use it as a capital budgeting threshold for the [required rate of return](https://www.investopedia.com/terms/r/requiredrateofreturn.asp)
5. **Capital Asset Pricing Model (CAPM)** describes the relationship between systematic risk and [expected return](https://www.investopedia.com/terms/e/expectedreturn.asp) for assets, particularly stocks.1 CAPM is widely used throughout finance for pricing risky [securities](https://www.investopedia.com/terms/s/security.asp) and generating expected returns for assets given the risk of those assets and [cost of capital](https://www.investopedia.com/terms/c/costofcapital.asp)
6. "**stock**" refers to ownership or equity in a firm. There are two types of equity—[common stock](https://www.investopedia.com/terms/c/commonstock.asp) and preferred stock. Preferred stockholders have a higher claim to [dividends](https://www.investopedia.com/terms/d/dividend.asp) or asset distribution than common stockholders. The details of each preferred stock depend on the issue
7. **Common stock** is a security that represents ownership in a corporation. Holders of common stock elect the [board of directors](https://www.investopedia.com/terms/b/boardoftrustees.asp) and vote on corporate policies.
8. **Preference shares**, more commonly referred to as [preferred stock](https://www.investopedia.com/terms/p/preferredstock.asp), are shares of a company’s stock with dividends that are paid out to shareholders before common stock dividends are issued
9. **Dividend** is the distribution of a company's earnings to its shareholders and is determined by the company's [board of directors](https://www.investopedia.com/terms/b/boardofdirectors.asp). Dividends are often distributed quarterly and may be paid out as cash or in the form of reinvestment in [additional stock](https://www.investopedia.com/terms/s/stockdividend.asp).
10. **Debt** is something, usually money, borrowed by one party from another. Debt is used by many corporations and individuals to make large purchases that they could not afford under normal circumstances
11. **Interest expense** is the cost incurred by an entity for borrowed funds. Interest expense is a [non-operating expense](https://www.investopedia.com/terms/n/non-operating-expense.asp) shown on the income statement.
12. **Retained earnings** are an important concept in accounting. The term refers to the historical profits earned by a company, minus any dividends it paid in the past. The word "retained" captures the fact that because those [earnings](https://www.investopedia.com/terms/e/earnings.asp) were not paid out to shareholders as dividends, they were instead retained by the company.
13. **Dividend payout ratio** is the ratio of the total amount of dividends paid out to shareholders relative to the net income of the company. It is the percentage of earnings paid to shareholders via dividends.