

Agency theory Agency theory says that a company is not a single, unified entity. It calls into question the claim that all of the stakeholders in the company (shareholders, managers and creditors) have a single goal – value creation. Agency theory shows how, on the contrary, their interests may differ and some decisions (related to borrowing, for example) or how products (stock options) come out of attempts to achieve convergence between the interests of managers and shareholders to protect creditors. It analyses the consequences of certain financial decisions in terms of risk, profitability and, more generally, the interests of the various parties. Agency theory is the intellectual basis of corporate governance.

Balance sheet The balance sheet represents a snapshot of the cumulative inflows and outflows previously generated by the business. It lists all the assets of a business and all of its financial resources at a given moment in time. The balance sheet is always at equilibrium, guaranteed by the double-entry accounting practice adopted by all businesses.

Beta Beta is the measure of the contribution of a single asset to the risk of portfolio. It is the covariance of this asset's returns with the returns of the market. Beta measures the volatility of a security.

Bond A bond is a negotiable debt security that is issued by corporations, municipalities and governments. It pays a coupon and is redeemed in accordance with its schedule of its issue. Bonds can carry other obligations on the part of the issuer. Bonds are the main medium-term market financing vehicles used by corporations, particularly in the 5–10-year segment. There are various types of bonds, such as plain vanilla convertible bonds, mandatory convertibles, exchangeable bonds, etc.

Capital Asset Pricing Model The CAPM is based on the assumption that investors act rationally and have at their disposal all relevant information on financial securities. It is the universally used tool for valuing financial securities. CAPM states that all investors should hold the market portfolio, and the risk premium they will demand is proportional to the market beta. According to CAPM, the expected return of an asset will then be a linear function of beta: Expected return of a financial security = Risk-free rate + Beta × (Expected return of the market – Risk-free rate).

Capital employed Capital employed is the sum of a company's fixed assets and its working capital (i.e., operating working capital and nonoperating working capital). It is therefore equal to the sum of the net amounts devoted by a business to the operating cycle

and investment cycle. Also known as operating assets. Capital employed is financed by two main types of funds, shareholders' equity and net debt, sometimes regrouped under the heading of invested capital.

Capital expenditures Capital expenditures are acquisitions of tangible fixed assets and intangible fixed assets. They are commonly called "capex". *See also* Investment.

Capital increase From a financial point of view, a capital increase is the sale of shares. Proceeds of this sale go to the company. A capital increase will lead to a change in different indicators: right to dividends, to profits, to liquidation sale proceeds, to equity, to voting rights amongst different funds providers. Capital increases can be made in cash or by asset contribution, following the exercise of warrants or a debt conversion, be reserved or not, and with or without preferential subscription rights.

Capital structure *See* Financial structure.

CAPM *See* Capital Asset Pricing Model.

Cash flow Cash flow is financing that is internally generated by the company. It is equal to EBITDA less net financial expense less corporate income tax. Cash flow can also be calculated by adding to net income depreciation, amortisation and impairment losses, the net result of asset disposals, and the net result of extraordinary events.

Cash flow statement A cash flow statement is a document containing the information about past trends in the cash flow of the company. Cash flows are usually classified by different categories. One of the possible classifications deals with the business cycle and the investment cycle, which form the industrial and commercial life of the company, and with the debt cycle and the equity cycle, which form the financing life of the company. The cash flow statement is also called the "statement of changes in financial position".

Comparables model The comparables model is a valuation model that compares all the observable values of assets that can be rationally compared – i.e., which have the same level of risk and growth. More often referred to as the multiples method.

Consolidation Consolidation is the process of creating the consolidated accounts whose purpose is to present the financial situation of a group of companies as if they formed one single entity. There are three consolidation methods, which are used depending on the strength of the parent company's control or influence: full consolidation, proportionate consolidation and the equity method. The basic principle consists in replacing the historical cost of the parent's investment in the company being consolidated with its assets, liabilities and equity. Consolidation sometimes stands for full consolidation.

Current assets Current assets consist of inventories, receivables (creditors in the UK), marketable securities and cash. This term reflects the fact that these assets tend to "turn over" during the operating cycle, as opposed to fixed assets, which are not destroyed by the operating cycle.

Debt Debt is the financing mode, which has the contractually fixed remuneration (*see* Interest rate) and repayment date. It is paid before equity, if and when the company is liquidated.

Dilution Dilution is the decrease in EPS. It is also the decline in the percentage of a current shareholder interest in the company – i.e., a decrease in his/her current voting rights. It occurs when a capital increase is cash-neutral for a shareholder. Also called dilution of control or real dilution. Where a parent company does not subscribe, either at all or only partially, to a capital increase by one of its subsidiaries that takes place above the subsidiary's book value, the parent company records a dilution profit. This is a noncash profit.

Discount rate Discount rate is the rate of return required for a project to compensate for its risk. Also called rate of discount.

Dividend Dividend is a part of net income distributed in cash to shareholders of the company.

Dividend yield Dividend yield per share is the ratio of the last dividend paid out to the current share price. It can be either gross (including the dividend tax credit if any) or net (without the dividend tax credit). Dividend yield is based on market value, never on book value.

Earning per share Earnings per share (EPS) represent one of the most widely used indicators measuring the performance of a company. It is calculated by dividing net income by the book value of shareholders' equity.

EBIT *See* Earnings before interest and tax.

EBITDA *See* Earnings before interest, tax, depreciation and amortisation.

Earnings before interest and tax EBIT represents the earnings generated by the investment cycle and business cycle for a given period. The term “business” contrasts with the term “financial”, reflecting the distinction between the real world and the realms of finance. EBIT is the product of the company's industrial and commercial activities before its financing operations are taken into account. Also called operating income, trading profit, operating profit or operating result.

Earnings before interest, tax, depreciation and amortisation EBITDA is the result of the operating cycle, which is equal to the balance of operating revenues and cash operating charges incurred to obtain these revenues. It is also called gross operating profit.

EBIT multiple The EBIT multiple is one of the enterprise value multiples. It is the ratio of the value of capital employed (enterprise value) to EBIT.

Efficient markets An efficient market is one in which the prices of financial securities at any time rapidly reflect all available relevant information. In such a market, future returns are unpredictable and prices of securities are always at their “right” value. An efficient market can be weak, semi-strong or strong. Also called perfect market or market in equilibrium.

Financial security Financial security is a contract whereby the issuer of the security commits to pay to the investor that lends the money today a stream of cash flows in accordance with a given timetable. Also called security.

Financial structure Financial structure is the proportion of net debt to equity in the company's financing. Capital structure is also called financial structure.

Fixed assets Fixed assets include everything required for the operating cycle that is not destroyed as part of it, as opposed to the current assets. The decrease in the value of fixed assets is accounted for through depreciation, amortisation and impairment losses. A distinction is drawn between tangible fixed assets (land, buildings, machinery, etc. – known as property, plant and equipment in the US), intangible fixed assets (brands, patents, goodwill, etc.) and investments. When a business holds shares in another company (in the long term), they are accounted for under investments. Accounting policy for fixed assets can significantly affect the accounting and financial criteria of the financial health of a company (profits, solvency, etc.). The state of a company's fixed assets is measured by the ratio net fixed assets/gross fixed assets.

Gearing Gearing is the ratio of net debt to equity. Also called leverage or financial leverage.

Goodwill Goodwill is the positive difference between the purchase cost and the fair market value of the assets and liabilities acquired with a company. It may exist due to one of the following: the assets recorded on the acquired company's balance sheet are worth more than their historical cost; some assets such as patents, licenses and market share that the company has accumulated over the years without wishing to or even being able to account for them, may not appear on the balance sheet; the merger between the two companies may create synergies, either in the form of cost reductions and/or revenue enhancement.

Holding company A holding company owns minority or majority investments in listed or unlisted companies either for purely financial reasons or for control purposes. It is a structure which enables the majority shareholder to maintain control of a company, because minority shareholders are dispersed.

Income statement The income statement is a document showing all wealth-creating revenues and wealth-destroying charges. There are two major income statement formats: the by-nature income statement format and the by-function income statement format. Also called profit and loss account (or P&L).

Interest rate The interest rate is interest expressed as an annual percentage rate. It is the cost of borrowing money; the price that a lender charges a borrower for the use of the lender's money.

Internal financing A company is financed internally when it ensures its development without using external financial resources. Even if internal financing is perceived favourably by the partners of the company, and protects the latter from risks related to an

excessive debt burden, internal financing can become harmful when it is used abusively. Its explicit cost being zero, internal financing can encourage not very profitable investment projects and thus cause the impoverishment of shareholders. Only the reinvestment of profits at a rate of return at least equal to cost of equity makes it possible to preserve the value of the reinvested profits.

Investment Investment is an outlay expected to increase operating cash flows in the future. Investments are carried out from a long-term perspective and have a longer life than that of the operating cycle. Unlike charges, investments are not destroyed in the operating cycle. Investment represents abstinence with a view of increasing future receipts. The increase must be sufficient to ensure the forecast return on investment. Investment is a fundamental process in the life of a company, engaging it for a long period.

LBO See Leveraged buyout.

Leveraged buyout A leveraged buyout is the acquisition of all a company's shares financed largely by borrowed funds. There are different types of LBOs: management buyout; BIMBO; leveraged buildup.

Leverage effect The leverage effect explains a company's return on equity in terms of its return on capital employed and cost of debt. It is the difference between return on equity and return on capital employed. It explains how it is possible for a company to deliver a return on equity exceeding the rate of return on all the capital invested in the business – i.e., its return on capital employed. When a company raises debt and invests the funds it has borrowed in its industrial and commercial activities, it generates operating profit that normally exceeds the interest expense due on its borrowings. The company generates a surplus consisting of the difference between the return on capital employed and the cost of debt related to the borrowing. This surplus is attributable to shareholders and is added to shareholders' equity. The leverage effect of debt thus increases the return on equity. If the return on capital employed falls below the cost of debt, then the leverage effect of debt shifts into reverse and reduces the return on equity, which in turn falls below the return on capital employed. The leverage effect is expressed in the following formula:

$$ROE = ROCE + (ROCE - i) \times D/E$$

where *ROE* is the return on equity, *ROCE* is the after-tax return on capital employed, *i* is the after-tax cost of debt, *D* is net debt, *E* is equity. The leverage effect itself is $(ROCE - i) \times D/E$.

Leverage See Gearing.

Market capitalisation Market capitalisation is the market value of a company's equity. It is obtained by multiplying the total number of shares outstanding by the share price.

Merger A merger consists in combining two or more companies, generally by offering the shareholders of one company securities of the other company in exchange for the surrender of their shares. Often called mergers, these business combinations are, however, almost always acquisitions. They can take the form of a legal merger, asset contribution or contribution of shares.

Modigliani–Miller theorem The Modigliani–Miller theorem, put forward in 1958, showed that in perfect markets and in the absence of taxation there is no such thing as an optimal capital structure; the overall cost of capital remains the same regardless of the firm’s debt policy. Thus, the value of the levered company is equal to the value of the unlevered company. This is the first proposition of the Modigliani–Miller theorem. The second proposition of the Modigliani–Miller theorem states that the cost of equity in a world without taxes rises with the increase in leverage. It can be computed as follows:

$$K_E = K_0 + (K_0 - K_D) \times V_D / V_E$$

where K_E is the cost of equity, K_0 is the cost of equity of an all-equity-financed company, K_D is the cost of debt, V_D is the value of debt and V_E is the value of equity.

Net debt See Net financial debt.

Net financial debt Net financial debt is the total financial debt net of short-term financial investments. Net financial debt and shareholders’ equity together represent the capital invested in the company. Also called net debt.

Net income Net income is profit after nonrecurrent items and tax. It is one of the most widely used accounting indicators of value creation. Net income is also called profit or earnings or net profit.

Net present value Net present value, or NPV, of a financial security is the difference between the present value of this security and its market value; NPV changes in the direction opposite to the change of the discounting rate. In an efficient market, NPVs are zero.

Operating assets Operating assets are all assets used in the company’s business activities. See also Capital employed.

Operating cash flow Operating cash flow is the balance of operating outflows and operating inflows generated by the business cycle of the business. It reflects the cash flows generated by operations during a given period. It represents the cash flow generated by the company’s day-to-day operations. Operating cash flow differs from EBITDA by the amount of change in the working capital. It is also equal to cash flow less the change in the operating working capital. Operating cash flow is a concept that depends on how expenditure is classified between operating outlays and investment outlays. Since this distinction is not always clearcut, operating cash flow is not widely used in practice, with free cash flow being far more popular. Also called cash flow from operating activities or cash flow from operations.

Operating income See EBIT.

Option An option is a contract between two parties, under which one party gives the other party the right (but not the obligation) to buy from it (a call option) or to sell to it (a put option) an underlying asset at a predetermined price (see strike price), in exchange

for the payment of a premium. Options can be in-the-money, at-the-money and out-of-the-money.

P/E Ratio, PER, price-to-earnings ratio The P/E ratio, one of the tools most commonly used for valuing a share, is the ratio of the share price to EPS. It can also be obtained by dividing market capitalisation by net income.

Price to Book Ratio (PBR) The price-to-book ratio is the ratio linking the price of the share with equity per share. It is the ratio of market value to book value.

Profit and loss account *See* Income statement.

Provisions The term “provision” covers a wide range of different items: impairment losses; provisions that reflect an increase in the company’s liabilities in the shorter or longer term relating to a charge that has not yet been incurred by the financial year-end, but is likely to arise and is connected with operations carried out during the year; tax-regulated provisions (strictly speaking they are not provisions). Aside from tax-regulated provisions, provisions are set aside in anticipation of a charge.

Rate of return The rate of return is the annual return expressed as a percentage of the total amount invested.

Return *See* Return on investment.

Return on investment Return on investment is the expected increase in the cash flows generated by the operating cycle as a result of investment outlays. It is compensation for forsaking instant consumption. Return on investment can simply be called return.

Return on capital employed – ROCE Return on capital employed measures the profitability of capital. It is calculated by dividing operating profit (NOPAT, if ROCE is to be measured on an after-tax basis) by capital employed. Return on capital employed can also be considered as the return on equity if net debt is zero. The capital employed can be taken for the beginning of the period in question, for the end of the period or the average over the year; ROCE can be calculated on a before- or after-tax basis. Return on capital employed can be calculated by combining operating margin and asset turnover as follows:

$$\frac{\text{Operating profit}}{\text{Capital employed}} = \frac{\text{Operating profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital employed}}$$

The first ratio – i.e., operating profit/sales – corresponds to the operating margin generated by the company, while the second – sales/capital employed – reflects asset turnover, which indicates the amount of capital (capital employed) required to generate a given level of sales. Return on capital employed is the most important accounting indicator of value creation.

Return on equity – ROE Return on equity measures the profitability of equity invested in the business. Return on equity is calculated by dividing net income by equity. It is

equal to return on capital employed plus the leverage effect. Return on equity is one of the accounting indicators of value creation.

Risk Risk is the uncertainty over future asset values and future returns. It is always present in any investment project. All risks lead to fluctuations in the value of a financial security. In a market economy, risk is measured by the volatility of the price and/or rate of return of a security. The degree of risk depends on the investment timeframe and tends to diminish over the long term.

Risk-free assets By definition, risk-free assets are those that offer a certain return – i.e., the risk-free rate (r_f). These assets are free of the default risk of the issuer and of the coupon reinvestment risk. This is the case with a government bond, assuming of course that the government does not go bankrupt. The standard deviation and variance of its return are thus zero.

Risk premium Risk premium is the difference between the expected return on a financial security and the return on a risk-free asset.

Share A share is a unit of equity ownership in a company. Shares thus constitute a source of financing for the company, just as debt instruments (or debts) do, even though there is clear and well-defined difference between the two. Shares have unlimited maturity (exit is only by transfer/sale of the share, there is no contractually fixed repayment date or value), and shareholders incur the same risks as the company. (They receive no income if the company is in poor health and, in the event of liquidation, shareholders are paid out after creditors when the proceeds of asset sales are distributed. In other words, most of the time, shareholders recover nothing after liquidation proceedings.) In exchange for this risk, a share entitles shareholders to a share in the company's profits and gives them a say in managing the company via voting rights. *See also* Shareholders' equity. Also called stock.

Share buyback A share buyback is the repurchase of the company's shares by the company itself on the open market. If shares are then cancelled, the share buyback amounts to capital decrease. Share buybacks are also used to control the shareholder structure by buying out "undesirable" shareholders.

Shareholders Shareholders are individuals or entities that provide a company with capital by buying shares (*see* this term) in the company. Inside shareholders and outside shareholders are two major categories of shareholder.

Shareholders' equity Shareholders' equity is the capital that incurs the risk of the business. This type of financial resource forms the cornerstone of the entire financial system. Its importance is such that shareholders providing it are granted decision-making powers and control over the business in various different ways. Dividends are a way of apportioning earnings voted on the ordinary general meeting of shareholders once the company's accounts have been approved. Shareholders' equity is not contractually remunerated, does not have a repayment date and, in case of liquidation of the company, is paid off only after debts are paid off. Shareholders' equity is equal to the sum of capital

increases by shareholders and annual net income for past years not distributed in the form of dividends plus the original share capital minus any amount spent on share buy-backs.

Signal theory A signal is a real financial decision, taken deliberately (e.g., dividend payout), and which may have negative financial consequences for the decision-maker if the decision turns out to be wrong.

Solvency Solvency reflects the ability of a company to honour its commitments in the event of liquidation – i.e., if its operations are wound up and assets are put up for sale. A company may be regarded as insolvent once its shareholders' equity turns negative. This means that it owes more than it owns.

Takeover bid A takeover bid is the attempt of one company to buy another company, either in a hostile or friendly manner. The potential acquirer usually offers to buy the target's shares at a higher price than the market price during a limited period.

Value The present value, or value of a financial security, is the present value of the expected future flows discounted (see discounting) at the rate of return required by investors. Value creation is the objective of any manager. This objective is reached when the investments of the company yield more than the return required by providers of funds.

Volatility Volatility of the value (or the rate of return) of a financial security characterises the amplitude of the fluctuations of this value (or return). Mathematically, volatility is the variance or the standard deviation. In a market economy, volatility measures the risk: the riskier a financial security, the higher its volatility, and vice versa.

Weighted Average Cost of Capital – WACC The weighted average cost of capital is the rate of return required by the providers of funds (shareholders and creditors) to finance the company's investment projects. It is the overall cost of financing of a company. According to the theory of markets in equilibrium, and provided there are no tax distortions, this cost is independent of the capital structure of the company; hence, an optimal capital structure does not exist. The weighted average cost of capital can be also called cost of capital.

Working capital The net balance of operating uses and sources of funds is called the working capital. If uses of funds exceed sources of funds, the balance is positive and working capital needs to be financed. This is the most frequent case. If negative, it represents a source of funds generated by the business cycle. It is described as "working capital" because the figure reflects the cash required to cover financing shortfalls arising from day-to-day operations. Working capital is totally independent of the methods used to value fixed assets, depreciation, amortisation and impairment losses on fixed assets. However, it is influenced by: inventory valuation methods; deferred income and expense (over one or more years); the company's provisioning policy for current assets and operating liabilities and expenses. Working capital can be also called working capital needs, working capital requirements and requirements for working capital.