Defining financial terms and role in finance

Finance

Defining Financial Terms and Role inFinanceUniversity of Phoenix FIN 370/ Finance for Business November 10, 2010 Defining Financial Terms and Role in Finance The following paragraphs contain financial terms and their role in finance. The terms are finance, efficient market, primary market, secondary market, risk, security, stock, bond, capital, debt, yield, rate of return, return on investment, and cash flow.

The fourteen terms all have an important relationship in the world of business. The first term is finance. Finance is managingmoneyor supplying funds to provide a resource. A bank or loan company is a source of finance because they both provide cash. Cash is the resource that one needs to survive or make a purchase. For instance, when a customer walks into a car dealership and is ready to buy a car, the salesperson draws up the paperwork and two items are in need. The first item is cash and the second is the search for a finance company to finance the car.

The role of finance in this example is the customer can provide the cash to make the purchase and the finance company can supply the funds and terms of agreement to help the owner purchase the car. The second term is efficient market. Efficient market is a hypothesis that prices prevail in the market is always fair. Its role in finance according to EMH is no one can make high return without buying riskier investment as market prices are always fair. The third term is primary market. Primary market is when securities, stocks and bonds, are offered to potential investors for the first time. Companies like Verizon or AT & T can issue or sell securities directly to an investor.

The primary market role in finance is to allow the potential investor to buy from the company and not other investors to increase the stock. The fourth term is secondary market. Secondary market is opposite of primary because it allows the investor to buy stocks and bonds from each other rather than the original company. The role of finance in secondary market is its affect on price. The price is more or less than the issue price of the original company. The fifth term is risk. Risk is the uncertainty or chance of a difference in the actual return earned on investment and the expected return earned on the investment.

There are three types of risk: market, credit, and operational. The company return on an investment depends on which risk the company took. For example, people and companies take risk sometimes when they make a financial investment or provide equipment and supplies for an opportunity to receive a high return on their investment. The role of finance for a risk is the uncertainty if they will receive payment for their investment. The higher the risk means the higher the return. The lower the risk means the lower the return. The next three terms have a correlation.

The terms are security, stock, and bond. Security in finance is the relationship and representation of stocks and bonds. Some securities are interest and dividend based. Common and preferred stock, bonds, notes, debenture, and option are some examples of securities. A stock represents ownership in a business, has face value, and may not carry a maturity date. A stock's role in finance is as follows. Common stock has no fixed rate of dividend and has voting rights.

Preferred stock has a fixed rate of dividend and no voting rights and preferred are the two types of stock. A bond is the last term of correlation. A bond is a fixed income security. A bond is a debt with interest, a maturity, mode of payment, and a principal. A bond's role in finance is that it can be issued as a long term debt and requires the company to pay on the interest even if they made a loss in profit or not. Capital is the amount of money an owner has invested in his or her business. The role of capital in finance is simple.

A sole proprietor has a single investment. A partnership has multiple investments and a corporation's amount of investment is shared by the stockholders. The capital has different amounts of investment in all three forms of businesses. In accounting, a debt is a liability to be paid back in terms to the source of finance. It can be long or short term. A debt's role in finance is that is an expense to a company that has interest payable. Rate of returned based on market price is called yield.

For example, if an investor has bought shares of $10 par and company declares dividend of 10% in cash and still the market is at par. IT means that yield earned on share is equal to dividend declared. Now if market price is different from par, say it is $20, now dividend declared is same but dividend yield is 5%. Any profit or loss that has been made for a specified period on investment is called the profit or loss in $ on your investment and when it is converted into percentage it is called rate of return. If a person invests $10, 000 in January and in December it increases to $12, 000, then the terms of investment for the year is $2, 000. The rate of return is 20% per annum because (2000/10000)*100= 20%. Return on investment is the profit or loss made on the investment.

Return on investment is similar to rate of return and is a ratio that describes the company's measurement of profit. For example, Tree and Rocks Company has profit after tax for year equal to $130 million and total assets are $1300 million, it means return on investment is 10%. Cash Flow is revenue received and paid in cash. The cash flow statement shows the cash inflows and outflows in real terms of a business. Operating, investing, and financing activities are three categories on a cash flow statement. The three categories and their role in finance are detrimental to the company. The revenue and expenses incurred during a specified time period are entered in the operating activities.

Buying and selling of fixed assets and other investments are entered in the investing activities. Long term debt, issuance of common and preferred stock is entered in the financing activities. The thirteen terms defined in the earlier paragraphs have a specific role in finance. The terms and their roles surround everyone in some situation every day. It is important to know the above terms and how they relate to one another in this course. Reference

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