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Dictionary of Finance and Investment Terms

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Charts and Graphs

Fifth Edition

John Downes
Jordan Elliot Goodman

Dictionary of Finance and Investment Terms

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PREFACE TO THE FIFTH EDITION

People retiring in the early years of the 21st century, the baby boom generation, have witnessed a revolution in the world of finance and investment. The forces of globalization assure that their children, face a future just as dynamic.

Deregulation of the securities, banking, and savings industries, starting in the 1970s, made a vast range of financial and investment products and services available to people at all economic levels. It also led to abuses and financial losses that required government intervention and a modernization of investor safeguards.

Merger mania in the "roaring 1980s" saw many of America's best-known corporations embroiled in hostile takeovers or leveraged buyouts financed by junk bonds, giving rise to defensive tactics known by such colorful names as the "poison pill," the "Pac-Man strategy," or the "white knight." Insider trading scandals were one result, but another was the innovation of investment techniques designed to capitalize on the profit opportunities created by corporate takeovers.

The 1990s brought corporate downsizing and restructuring, massive stock buybacks, strategic mergers on a global scale, and a prolonged bull market fueled by corporate profitability, low inflation, and sustained economic growth.

With globalization, the world's economies, more free of trade and economic barriers, have become more interdependent and in some ways more vulnerable. On the eve of the new millennium, floundering Asian economies and a recession in Japan threatened markets in the United States and challenged the confidence of a new European Monetary Union with its common currency, the Euro, and its promise of expanded financial markets.

Advanced communications systems have created both greater simplicity and greater complexity in the more unified world of finance and investment. By linking markets and processing massive information, these systems have given rise to investment vehicles, transactions, and methods of managing risk not previously imaginable.

The generation produced by the baby boomers must plan its personal finances in an economy offering less assurance of future financial security. The restructurings of the 1990s made corporations more efficient but took their human toll, just as the demographics that earlier created surpluses in the Social Security system became less favorable for future recipients. The enormous growth of 401(k) and individual retirement accounts, addresses this problem but also points to its gravity.

The introduction of Roth IRAs, the lowering of long-term capital gains tax rates, and other provisions of the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998, also recognize the increasing importance of self-reliance in personal financial planning.

This thoroughly revised *Dictionary of Finance and Investment Terms* covers the 20th century's major developments in investments, taxation, economics, consumer and corporate finance, and related fields. Adding a more comprehensive global dimension, it defines and clarifies the language that will be used in financial decision-making in the new millennium.

We wish especially to acknowledge Roberta Yafie, whose fact-checking and research went well beyond the call of duty; Mary Falcon, Barron's editor, who ably and patiently coordinated an immense amount of detail; and our original Barron's editor, Tom Hirsch. Suzanne and Jason Goodman, Katie and Annie Downes, and Nancy Weinberg all sacrificed unselfishly at different stages of the project and we thank them.

We also thank *Accounting Today*, American Association of Individual Investors, American Bankers Association, American Council of Life Insurance, American Express Company, American Institute of Certified Public Accountants, American Society of CLU & ChFC (Chartered Life Underwriters), American Stock Exchange, Associated Credit Bureaus, Bankers Trust Company, A.M. Best & Company, The Bond Buyer, Bond Market Association, Boston Stock Exchange, Chase Manhattan Bank NA, Chicago Board of Trade, Chicago Board Options Exchange, Chicago Mercantile Exchange, Cincinnati Stock Exchange, Coffee, Sugar & Cocoa Exchange, COMEX, Commodity Futures Trading Commission, Dow Jones & Company, Employee Benefit Research Institute, The European Commission, Fannie Mae, Federal Energy Regulatory Commission, Federal Reserve Bank of New York, Federal Trade Commission, FINEX, Frank Russell Company, Futures Industry Association, Goldman Sachs & Company, Health Insurance Institute of America, Hulbert Financial Digest, IBC Organization, I/B/E/S Incorporated, Insurance Information Institute, Intermarket Management Incorporated, Internal Revenue Service, International Petroleum Exchange, International Swaps and Derivatives Association, Investment Management Consultants Association, Investment Program Association, J.P. Morgan, Kansas City Board of Trade, Richard J. Kittrell, Esq/ Kittrell & Kittrell P.C., Liquidity Financial Corporation, Mercer and Company, Merrill Lynch, Minneapolis Grain Exchange, Montreal Exchange/Bourse de Montreal, Morgan Stanley Dean Witter, Morningstar, Mortgage Bankers Association, Municipal Bond Investors Assurance Corporation, National Association of Investors Corporation, National Association of Real Estate Investment Trusts, National Association of Realtors, National Association of Securities Dealers, National Association of Variable Annuities, National Credit Union Administration, New York Cotton Exchange, New York Futures Exchange, New York Life Insurance Company, New York Mercantile Exchange, New York Stock Exchange, Office of Thrift Supervision, Options Clearing Corporation, Options Institute, Pacific Exchange, Pension Benefit Guaranty Corporation, Philadelphia Stock Exchange, Prudential Securities, Salomon Smith Barney, Securities and Exchange Commission, Securities Industry Association, Standard & Poor's, Toronto Stock Exchange, Trimedia Incorporated, U.S. Department of Commerce, U.S. Department of Labor, Value Line Investment Survey, Vancouver Stock Exchange, Visa International, The Weiser Group, Wheat First Butcher Singer Incorporated, Wilshire Associates, Winnipeg Commodity Exchange, World Gold Council, Wrap Industry Association, and Zacks Investment Research.

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Jordan Elliot Goodman

HOW TO USE THIS BOOK EFFECTIVELY

Alphabetization: All entries are alphabetized by letter rather than by word so that multiple-word terms are treated as single words. For example, **NET ASSET VALUE** follows **NET ASSETS** as though it were spelled **NETASSETVALUE,** without spacing. Similarly, **ACCOUNT EXECUTIVE** follows **ACCOUNTANT'S OPINION.** In unusual cases, abbreviations or acronyms appear as entries in the main text, in addition to appearing in the back of the book in the separate listing of Abbreviations and Acronyms. This is when the short form, rather than the formal name, predominates in common business usage. For example, NASDAQ is more commonly used in speaking of the National Association of Securities Dealers Automated Quotations system than the name itself, so the entry is at **NASDAQ.** Numbers in entry titles are alphabetized as if they were spelled out.

Abbreviations and Acronyms: A separate list of abbreviations and acronyms follows the Dictionary. It contains shortened versions of terms defined in the book, plus several hundred related business terms.

Cross references: In order to gain a fuller understanding of a term, it will sometimes help to refer to the definition of another term. In these cases the additional term is printed in SMALL CAPITALS. Such cross references appear in the body of the definition or at the end of the entry (or sub-entry). Cross references at the end of an entry (or sub-entry) may refer to related or contrasting concepts rather than give more information about the concept under discussion. As a rule, a term is printed in small capitals only the first time it appears in an entry. Where an entry is fully defined at another entry, a reference rather than a definition is provided; for example, **EITHER-OR ORDER** *see* ALTERNATIVE ORDER.

Italics: Italic type is generally used to indicate that another term has a meaning identical or very closely related to that of the entry. Occasionally, italic type is also used to highlight the fact that a word used is a business term and not just a descriptive phrase. Italics are also used for the titles of publications.

Parentheses: Parentheses are used in entry titles for two reasons. The first is to indicate that an entry's opposite is such an integral part of the concept that only one discussion is necessary; for example, **REALIZED PROFIT (OR LOSS).** The second and more common reason is to indicate that an abbreviation is used with about the same frequency as the term itself; for example, **OVER THE COUNTER (OTC).**

Examples, Illustrations, and Tables: The numerous examples in this Dictionary are designed to help readers gain understanding and to help them relate abstract concepts to the real world of finance and investment. Line drawings are provided in addition to text to clarify concepts best understood visually; for example, technical chart patterns used by securities analysts and graphic concepts used in financial analysis.

CONTENTS

A

ABANDONMENT voluntarily giving up all rights, title, or claims to property that rightfully belongs to the owner. An example of abandoned property would be stocks, bonds, or mutual funds held in a brokerage account for which the firm is unable to locate the listed owner over a specified period of time, usually a few years. If ruled to be abandoned, the property may revert to the state under the laws of ESCHEAT. In addition to financial assets, other kinds of property that are subject to abandonment include patents, inventions, leases, trademarks, contracts, and copyrights.

ABC AGREEMENT agreement between a brokerage firm and one of its employees spelling out the firm's rights when it purchases a New York Stock Exchange membership for the employee. Only individuals can be members of the NYSE, and it is common practice for a firm to finance the purchase of a membership, or SEAT, by one of its employees. The NYSE-approved ABC Agreement contains the following provisions regarding the future disposition of the seat: (1) The employee may retain the membership and buy another seat for an individual designated by the firm. (2) The employee may sell the seat and give the proceeds to the firm. (3) The employee may transfer the seat to another employee of the firm.

ABILITY TO PAY
Finance: borrower's ability to meet principal and interest payments on long-term obligations out of earnings. Also called *ability to service. See also* FIXED CHARGE COVERAGE.
Industrial relations: ability of an employer, especially a financial organization to meet a union's financial demands from operating income.
Municipal bonds: issuer's present and future ability to generate enough tax revenue to meet its contractual obligations, taking into account all factors concerned with municipal income and property values.
Taxation: the concept that tax rates should vary with levels of wealth or income; for example, the progressive income tax.

ABOVE PAR *see* PAR VALUE.

ABS *see* AUTOMATED BOND SYSTEM.

ABSOLUTE PRIORITY RULE *see* BANKRUPTCY.

ABSORBED
Business: a cost that is treated as an expense rather than passed on to a customer.
Also, a firm merged into an acquiring company.
Cost accounting: indirect manufacturing costs (such as property taxes and insurance) are called absorbed costs. They are differentiated from

variable costs (such as direct labor and materials). *See also* DIRECT OVERHEAD.

Finance: an account that has been combined with related accounts in preparing a financial statement and has lost its separate identity. Also called *absorption account* or *adjunct account.*

Securities: issue that an underwriter has completely sold to the public.

Also, in market trading, securities are absorbed as long as there are corresponding orders to buy and sell. The market has reached the *absorption point* when further assimilation is impossible without an adjustment in price. *See also* UNDIGESTED SECURITIES.

ABUSIVE TAX SHELTER LIMITED PARTNERSHIP the Internal Revenue Service deems to be claiming illegal tax deductions—typically, one that inflates the value of acquired property beyond its fair market value. If these writeoffs are denied by the IRS, investors must pay severe penalties and interest charges, on top of back taxes.

ACCELERATED COST RECOVERY SYSTEM (ACRS) provision instituted by the ECONOMIC RECOVERY TAX ACT OF 1981 (ERTA) and modified by the TAX REFORM ACT OF 1986, which established rules for the DEPRECIATION (the recovery of cost through tax deductions) of qualifying assets within a shorter period than the asset's expected useful (economic) life. With certain exceptions, ACRS rules provided for greater acceleration over longer periods of time than ERTA rules, and were effective for property placed in service between 1980 and 1987.

See also MODIFIED ACCELERATED COST RECOVERY SYSTEM.

ACCELERATED DEPRECIATION Internal Revenue Service-approved methods used in the DEPRECIATION of fixed assets placed in service prior to 1980 when the ACCELERATED COST RECOVERY SYSTEM (ACRS) became mandatory. Such methods provided for faster recovery of cost and earlier tax advantages than traditional STRAIGHT LINE DEPRECIATION and included such methods as DOUBLE-DECLINING BALANCE METHOD (now used in some ACRS classes) and SUM-OF-THE-YEARS' DIGITS METHOD.

ACCELERATION CLAUSE provision, normally present in an INDENTURE agreement, mortgage, or other contract, that the unpaid balance is to become due and payable if specified events of default should occur. Such events include failure to meet interest, principal, or sinking fund payments; insolvency; and nonpayment of taxes on mortgaged property.

ACCEPTANCE

In general: agreement created when the drawee of a TIME DRAFT (bill of exchange) writes the word "accepted" above the signature and designates a date of payment. The drawee becomes the acceptor, responsible for payment at maturity.

Also, paper issued and sold by sales finance companies, such as General Motors Acceptance Corporation.

Banker's acceptance: time draft drawn on and accepted by a bank, the customary means of effecting payment for merchandise sold in import-export transactions and a source of financing used extensively in international trade. With the credit strength of a bank behind it, the banker's acceptance usually qualifies as a MONEY MARKET instrument. The liability assumed by the bank is called its acceptance liability. *See also* LETTER OF CREDIT.

Trade acceptance: time draft drawn by the seller of goods on the buyer, who becomes the acceptor, and which is therefore only as good as the buyer's credit.

ACCOMMODATIVE MONETARY POLICY Federal Reserve policy to increase the amount of money available for lending by banks. When the Fed implements an accommodative policy, it is known as easing the money supply. During a period of easing, interest rates fall, making it more attractive for borrowers to borrow, thereby stimulating the economy. The Fed will initiate an accommodative policy when interest rates are high, the economy is weak, and there is little fear of an outbreak of inflation. Once interest rates have been lowered enough to stimulate the economy, the Fed may become concerned about inflation again and switch to a TIGHT MONEY policy. *See also* MONETARY POLICY.

ACCOUNT

In general: contractual relationship between a buyer and seller under which payment is made at a later time. The term *open account* or *charge account* is used, depending on whether the relationship is commercial or personal.

Also, the historical record of transactions under the contract, as periodically shown on the *statement of account.*

Banking: relationship under a particular name, usually evidenced by a deposit against which withdrawals can be made. Among them are demand, time, custodial, joint, trustee, corporate, special, and regular accounts. Administrative responsibility is handled by an *account officer.*

Bookkeeping: assets, liabilities, income, and expenses as represented by individual ledger pages to which debit and credit entries are chronologically posted to record changes in value. Examples are cash, accounts receivable, accrued interest, sales, and officers' salaries. The system of recording, verifying, and reporting such information is called accounting. Practitioners of accounting are called *accountants.*

Investment banking: financial and contractual relationship between parties to an underwriting syndicate, or the status of securities owned and sold.

Securities: relationship between a broker-dealer firm and its client wherein the firm, through its registered representatives, acts as agent in buying and selling securities and sees to related administrative matters. *See also* ACCOUNT EXECUTIVE; ACCOUNT STATEMENT.

ACCOUNTANT'S OPINION statement signed by an independent public accountant describing the scope of the examination of an organization's books and records. Because financial reporting involves considerable discretion, the accountant's opinion is an important assurance to a lender or investor. Depending on the scope of an audit and the auditor's confidence in the veracity of the information, the opinion can be unqualified or, to some degree, qualified. Qualified opinions, though not necessarily negative, warrant investigation. Also called *auditor's certificate.*

ACCOUNT BALANCE net of debits and credits at the end of a reporting period. Term applies to a variety of account relationships, such as with banks, credit card companies, brokerage firms, and stores, and to classifications of transactions in a bookkeeping system. The same account may be an asset account balance or a liability account balance, depending on which side of the transaction you are on. For example, your bank balance is an asset account to you and a liability account to the bank. Your credit card (debit) balance is a liability account to you and an asset account (account receivable) to the credit card company.

ACCOUNT EXECUTIVE brokerage firm employee who advises and handles orders for clients and has the legal powers of an AGENT. Every account executive must pass certain tests and be registered with the NATIONAL ASSOCIATION OF SECURITIES DEALERS (NASD) before soliciting orders from customers. Also called *registered representative. See also* BROKER.

ACCOUNTING PRINCIPLES BOARD (APB) board of the American Institute of Certified Public Accountants (AICPA) that issued (1959–73) a series of ACCOUNTANT'S OPINIONS constituting much of what is known as GENERALLY ACCEPTED ACCOUNTING PRINCIPLES. *See also* FINANCIAL ACCOUNTING STANDARDS BOARD (FASB).

ACCOUNT RECONCILIATION the process of adjusting the balance in your checkbook to match your bank statement. Your checkbook balance, plus outstanding checks, less bank charges, plus interest (if any), should equal the balance shown on your bank statement.

ACCOUNTS PAYABLE amounts owing on open account to creditors for goods and services. Analysts look at the relationship of accounts payable to purchases for indications of sound day-to-day financial management. *See also* TRADE CREDIT.

ACCOUNTS RECEIVABLE money owed to a business for merchandise or services sold on open account, a key factor in analyzing a company's LIQUIDITY—its ability to meet current obligations without additional revenues. *See also* ACCOUNTS RECEIVABLE TURNOVER; AGING SCHEDULE; COLLECTION RATIO.

ACCOUNTS RECEIVABLE FINANCING short-term financing whereby accounts receivable serve as collateral for working capital advances. *See also* FACTORING.

ACCOUNTS RECEIVABLE TURNOVER ratio obtained by dividing total credit sales by accounts receivable. The ratio indicates how many times the receivables portfolio has been collected during the accounting period. *See also* ACCOUNTS RECEIVABLE; AGING SCHEDULE; COLLECTION RATIO.

ACCOUNT STATEMENT
In general: any record of transactions and their effect on charge or open-account balances during a specified period.
Banking: summary of all checks paid, deposits recorded, and resulting balances during a defined period. Also called a *bank statement.*
Securities: statement summarizing all transactions and showing the status of an account with a broker-dealer firm, including long and short positions. Such statements must be issued quarterly, but are generally provided monthly when accounts are active. Also, the OPTION AGREEMENT required when an option account is opened.

ACCREDITED INVESTOR under Securities and Exchange Commission Regulation D, a wealthy investor who does not count as one of the maximum of 35 people allowed to put money into a PRIVATE LIMITED PARTNERSHIP. To be accredited, such an investor must have a net worth of at least $1 million or an annual income of at least $200,000, or must put at least $150,000 into the deal, and the investment must not account for more than 20% of the investor's worth. Private limited partnerships use accredited investors to raise a larger amount of capital than would be possible if only 35 less-wealthy people could contribute.

ACCRETION
1. asset growth through internal expansion, acquisition, or such causes as aging of whisky or growth of timber.
2. adjustment of the difference between the price of a bond bought at an original discount and the par value of the bond.

ACCRUAL BASIS accounting method whereby income and expense items are recognized as they are earned or incurred, even though they may not have been received or actually paid in cash. The alternative is CASH BASIS accounting.

ACCRUAL BONDS bonds that do not make periodic interest payments, but instead accrue interest until the bond matures. Also known as *zero-coupon bonds. See also* ZERO-COUPON SECURITIES.

ACCRUED BENEFITS pension benefits that an employee has earned based on his or her years of service at a company. *See also* VESTING.

ACCRUED INTEREST interest that has accumulated between the most recent payment and the sale of a bond or other fixed-income security. At the time of sale, the buyer pays the seller the bond's price plus accrued interest, calculated by multiplying the coupon rate by the number of days that have elapsed since the last payment.

Accrued interest is also used in a real estate LIMITED PARTNERSHIP when the seller of a building takes a lump sum in cash at the time of sale and gives a second mortgage for the remainder. If the rental income from the building does not cover the mortgage payments, the seller agrees to let the interest accrue until the building is sold to someone else. Accrued interest deals were curtailed by the 1984 tax act.

ACCRUED MARKET DISCOUNT increase in market value of a DISCOUNT BOND that occurs because of its approaching MATURITY DATE (when it is redeemable at PAR) and not because of declining market interest rates.

ACCUMULATED DIVIDEND dividend due, usually to holders of cumulative preferred stock, but not paid. It is carried on the books as a liability until paid. *See also* CUMULATIVE PREFERRED.

ACCUMULATED PROFITS TAX surtax on earnings retained in a business to avoid the higher personal income taxes they would be subject to if paid out as dividends to the owners.

Accumulations above the specified limit, which is set fairly high to benefit small firms, must be justified by the reasonable needs of the business or be subject to the surtax. Because determining the reasonable needs of a business involves considerable judgment, companies have been known to pay excessive dividends or even to make merger decisions out of fear of the accumulated profits tax. Also called *accumulated earnings tax.*

ACCUMULATION

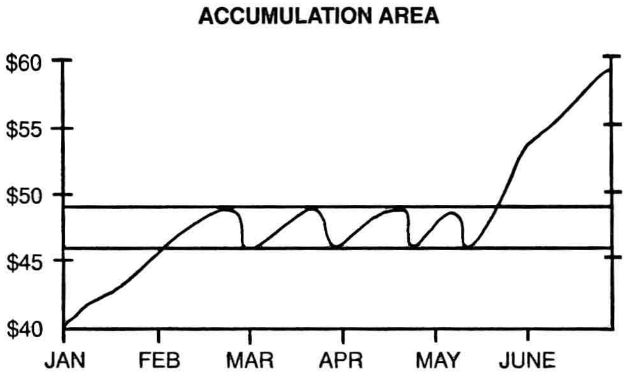
Corporate finance: profits that are not paid out as dividends but are instead added to the company's capital base. *See also* ACCUMULATED PROFITS TAX.

Investments: purchase of a large number of shares in a controlled way so as to avoid driving the price up. An institution's accumulation program, for instance, may take weeks or months to complete.

Mutual funds: investment of a fixed dollar amount regularly and reinvestment of dividends and capital gains.

ACCUMULATION AREA price range within which buyers accumulate shares of a stock. Technical analysts spot accumulation areas when a stock does not drop below a particular price. Technicians who use the ON-BALANCE VOLUME method of analysis advise buying stocks that have hit their accumulation area, because the stocks can be expected to attract more buying interest. *See* chart on next page. *See also* DISTRIBUTION AREA.

ACES acronym for *Advanced Computerized Execution System,* run by the NASDAQ stock market. ACES automates trades between order-entry and market-maker firms that have established trading relationships with each other, designating securities at specified quantities for automatic execution. Once trading parameters are set, ACES facilitates order entry, best-price order execution and limited-order maintenance, as well as a variety of inventory control capabilities. Trades are then automatically reported for public dissemination and sent for comparison and clearing.



ACID-TEST RATIO *See* QUICK RATIO.

ACKNOWLEDGMENT verification that a signature on a banking or brokerage document is legitimate and has been certified by an authorized person. Acknowledgment is needed when transferring an account from one broker to another, for instance. In banking, an acknowledgment verifies that an item has been received by the paying bank and is or is not available for immediate payment.

ACQUIRED SURPLUS uncapitalized portion of the net worth of a successor company in a POOLING OF INTERESTS combination. In other words, the part of the combined net worth not classified as CAPITAL STOCK.

In a more general sense, the surplus acquired when a company is purchased.

ACQUISITION one company taking over controlling interest in another company. Investors are always looking out for companies that are likely to be acquired, because those who want to acquire such companies are often willing to pay more than the market price for the shares they need to complete the acquisition. *See also* MERGER; POOLING OF INTERESTS; TAKEOVER.

ACQUISITION COST

Finance: price plus CLOSING COSTS to buy a company, real estate or other property.

Investments: SALES CHARGE incurred to buy a LOAD FUND or the original price, plus brokerage commissions, of a security. *See also* TAX BASIS.

ACROSS THE BOARD movement in the stock market that affects almost all stocks in the same direction. When the market moves up across the board, almost every stock gains in price.

An across-the-board pay increase in a company is a raise of a fixed percent or amount for all employees.

ACTING IN CONCERT two or more investors working together to achieve the same investment goal—for example, all buying stock in a company they want to take over. Such investors must inform the Securities and Exchange Commission if they intend to oust the company's top management or acquire control. It is illegal for those acting in concert to manipulate a stock's price for their own gain.

ACTIVE ACCOUNT account at a bank or brokerage firm in which there are many transactions. An active banking account may generate more fees for each check written or ATM transaction completed. An active brokerage account will generate more commission revenue for the brokerage firm than an inactive account. Banks usually impose minimum charges for maintaining a checking and savings account. Many brokerage firms levy a fee if an account does not generate a high enough level of activity. If there is no activity in an account for five years or more, the account may be subject to ESCHEAT procedures in which the account's assets revert to the state.

ACTIVE BOND CROWD members of the bond department of the New York Stock Exchange responsible for the heaviest volume of bond trading. The opposite of the active crowd is the CABINET CROWD, which deals in bonds that are infrequently traded. Investors who buy and sell bonds in the active crowd will tend to get better prices for their securities than in the inactive market, where spreads between bid and asked prices are wider.

ACTIVE BOX collateral available for securing brokers' loans or customers' margin positions in the place—or *box*—where securities are held in safekeeping for clients of a broker-dealer or for the broker-dealer itself. Securities used as collateral must be owned by the firm or hypothecated—that is, pledged or assigned—by the customer to the firm, then by the broker to the lending bank. For margin loans, securities must be hypothecated by the customer to the broker.

ACTIVE MARKET heavy volume of trading in a particular stock, bond, or commodity. The spread between bid and asked prices is usually narrower in an active market than when trading is quiet.

Also, a heavy volume of trading on the exchange as a whole. Institutional money managers prefer such a market because their trades of large blocks of stock tend to have less impact on the movement of prices when trading is generally active.

ACTUALS any physical commodity, such as gold, soybeans, or pork bellies. Trading in actuals ultimately results in delivery of the commodity to the buyer when the contract expires. This contrasts with trading in commodities of, for example, index options, where the contract is settled in cash, and no physical commodity is delivered upon expiration. However, even when trading is in actuals most futures and options contracts are closed out before the contract expires, and so these transactions do not end in delivery.

ACTUARY mathematician employed by an insurance company to calculate premiums, reserves, dividends, and insurance, pension, and annuity rates, using risk factors obtained from experience tables. These tables are based on both the company's history of insurance claims and other industry and general statistical data.

ADDITIONAL BONDS TEST test limiting the amount of new bonds that can be issued. Since bonds are secured by assets or revenues of a corporate or governmental entity, the underwriters of the bond must insure that the bond issuer can meet the debt service requirements of any additional bonds. The test usually sets specific financial benchmarks, such as what portion of an issuer's revenues or cash flow can be devoted to paying interest.

ADDITIONAL PAID-IN CAPITAL *see* PAID-IN CAPITAL.

ADDITIONAL VOLUNTARY CONTRIBUTIONS contributions made by an employee into a tax-deferred savings account, such as a 401(k) or 403(b), beyond the level at which an employer will match the investment. Depending on the level of contributions, these may be made on a pretax or aftertax basis. Tax law limits the total amount of money that can be contributed to such a tax-deferred account. In any case, all funds so contributed accumulate without taxation until withdrawn at retirement. The employee chooses the investment vehicles in which the money is invested.

ADEQUACY OF COVERAGE test of the extent to which the value of an asset, such as real property, securities, or a contract subject to currency exchange rates, is protected from potential loss either through INSURANCE or HEDGING.

ADJUSTABLE RATE MORTGAGE (ARM) mortgage agreement between a financial institution and a real estate buyer stipulating predetermined adjustments of the interest rate at specified intervals. Mortgage payments are tied to some index outside the control of the bank or savings and loan institution, such as the interest rates on U.S. Treasury bills or the average national mortgage rate. Adjustments are made regularly, usually at intervals of one, three, or five years. In return for taking some of the risk of a rise in interest rates, borrowers get lower rates at the beginning of the ARM than they would if they took out a fixed rate mortgage covering the same term. A homeowner who is worried about sharply rising interest rates should probably choose a fixed rate mortgage, whereas one who thinks rates will rise modestly, stay stable, or fall should choose an adjustable rate mortgage. Critics of ARMs charge that these mortgages entice young homeowners to undertake potentially onerous commitments.

Also called a Variable Rate Mortgage (VRM), the ARM should not be confused with the GRADUATED PAYMENT MORTGAGE, which is issued at a fixed rate with monthly payments designed to increase as the borrower's income grows. *See also* CAP; COST OF FUNDS; GROWING EQUITY MORTGAGE; MORTGAGE INTEREST DEDUCTION; SELF-AMORTIZING MORTGAGE; SHARED APPRECIATION MORTGAGE; TEASER RATE.

ADJUSTABLE RATE PREFERRED STOCK (ARPS) PREFERRED STOCK, whose dividend instead of being fixed is adjusted, usually quarterly, based on changes in the Treasury bill rate or other money market rate. The prices of adjustable rate preferreds are less volatile than fixed rate preferreds. Also called *floating rate* or *variable rate* preferred. *See also* CAPS; DUTCH AUCTION PREFERRED STOCK; MANDATORY CONVERTIBLES.

ADJUSTED BALANCE METHOD formula for calculating finance charges based on ACCOUNT BALANCE remaining after adjusting for payments and credits posted during the billing period. Interest charges under this method are lower than those under the AVERAGE DAILY, PREVIOUS BALANCE, and PAST DUE BALANCE METHODS.

ADJUSTED BASIS base price from which to judge capital gains or losses upon sale of an asset like a stock or bond. The cost of commissions in effect is deducted at the time of sale when net proceeds are used for tax purposes. The price must be adjusted to account for any stock splits that have occurred since the initial purchase before arriving at the adjusted basis.

ADJUSTED DEBIT BALANCE (ADB) formula for determining the position of a margin account, as required under Regulation T of the Federal Reserve Board. The ADB is calculated by netting the balance owing the broker with any balance in the SPECIAL MISCELLANEOUS ACCOUNT (SMA), and any paper profits on short accounts. Although changes made in Regulation T in 1982 diminished the significance of ADBs, the formula is still useful in determining whether withdrawals of cash or securities are permissible based on SMA entries.

ADJUSTED EXERCISE PRICE term used in put and call options on Government National Mortgage Association (Ginnie Mae) contracts. To make sure that all contracts trade fairly, the final exercise price of the option is adjusted to take into account the coupon rates carried on all GNMA mortgages. If the standard GNMA mortgage carries an 8% yield, for instance, the price of GNMA pools with 12% mortgages in them are adjusted so that both instruments have the same yield to the investor.

ADJUSTED GROSS INCOME (AGI) income on which an individual or couple computes federal income tax. AGI is determined by subtracting from gross income any unreimbursed business expenses and other allowable adjustments—for example, INDIVIDUAL RETIREMENT