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9B19B006

NOTE ON FINANCIAL ACCOUNTING: THE FINANCIAL ACCOUNTING ‘TERM SHEET’

Michael Saunders and Alex Solomos wrote this note under the supervision of Professor Matthew Sooy solely to provide material for class discussion. The authors do not intend to provide legal, tax, accounting or other professional advice. Such advice should be obtained from a qualified professional.

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This technical note serves as a glossary constructed to ease students’ transition into financial accounting courses. The glossary includes both foundational terms that are widely used and terms introduced in one or more common financial accounting cases. The terms are explained in a manner intended to inform both novice and advanced students.

The list has been constructed in part based on student-requested terms. Suggestions for additional unfamiliar terms that might benefit this glossary are welcomed. Please forward any suggested glossary terms to [msooy@ivey.ca](mailto:msooy@ivey.ca).

**GLOSSARY OF USEFUL AND VALUABLE TERMS (AND OTHER BUSINESS JARGON)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Acid test | Evaluating investment targets | This measure of liquidity is calculated by adjusting the current ratio to remove illiquid assets (primarily, inventory), as follows: | Meeting short-term obligations is necessary to avoid insolvency or bankruptcy, even for large firms with valuable and productive assets. Both the acid test and the current ratio (see Current ratio) are reflective of companies’ ability to meet short-term obligations. The acid test is a more conservative measure than the current ratio because it excludes certain current assets that may be difficult to liquidate. |
| Amortization versus depreciation | Evaluating investment targets | Broadly, both amortization and depreciation relate to an asset’s loss of value over its life. Amortization and depreciation both spread out the cost of a long-lived asset across different reporting periods. Amortization usually describes *intangible* or *financial* assets, whereas depreciation is commonly used with *tangible* assets. | Almost all income statements, balance sheets, and cash-flow statements have some use for the terms amortization and depreciation, which allocate *lumpy* cash outlays across the asset’s lifespan. With enhanced financial accounting study and increased learning about companies with higher intangible asset values, amortization plays a larger role, which must be fully understood and analyzed. |
| Annual run rate | Evaluating investment targets | The annual run rate is an estimate of what *will be* the total annual amount, based on partial year results. Annual run rate is typically calculated by extending current results to the end of the year. For example, if two of four quarters have passed, current results would be multiplied by 2 to arrive at the annual run rate, calculated as follows: | Investors and managers often make projections for annual results based on partial-year results. The annual run rate is a term used to indicate that the figure is an estimate of the future based on incomplete results. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Bank debt | General investing | Bank debt refers to loans issued by a commercial bank (or similar financial institution), typically referring to long-term loans. Bank debt typically has a lower interest rate than other forms of financing, but also requires some form of collateral that the lending institution has claim on if the debt cannot be repaid. | Bank debt is one of the most common forms of debt a company can obtain. It commonly appears in many financial statements. For individuals, it is the most likely type of debt obtained by borrowers for the purchase of a house.  It is important to track the lifespan of an asset (short-term or long-term) and the funding used to finance that asset to avoid payments for the asset after the end of its productive life. Many ratios pertaining to debt are used in respect to both financial accounting and finance.  It is sometimes helpful to distinguish between interest-bearing liabilities (such as bank debt) and liabilities that do not bear interest (such as wages payable). |
| Basis point | General investing | A basis point is a numerical value that represents 100th of 1 per cent. For example, 50 basis points represents 0.5 per cent (e.g., 0.0005). | Many securities and interest rates trade at values with many decimal places. When describing a price change, many analysts refer to basis points to more accurately describe the value of the asset or rate. |
| Book value | Evaluating investment targets | A company’s book value is typically the carrying value of its total assets, which represent their net value, including all contra-asset accounts that offset original prices (e.g., depreciation and amortization). | It is helpful to compare a company’s book value to its market cap (this ratio is called the market-to-book ratio). Generally, a company’s market value is greater than its book value. The difference represents all of the future cash flows the company is projected to make (discounted because they occur in the future). In rare cases, a company’s market value may drop to near or below its book value; however, these are typically firms approaching bankruptcy valued at the possibility of liquidation, rather than as a viable business. |

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Buy-side analyst versus sell-side analyst | General investing | Both buy-side and sell-side analysts offer recommendations and advice to their clients, who are typically in a merger or acquisition process (i.e., one firm is offering to purchase the other). The buy-side analyst provides advice to the *purchasing* firm, generally regarding purchase price and value. The sell-side analyst provides similar advice to the *selling* firm. | Understanding the difference between the buy side and the sell side is important because many firms that operate in the capital markets are exposed to some form of acquisition (e.g., purchase or sale). Many students will be seeking analyst roles for either the buy side or the sell side after graduation, so understanding the terminology is useful to better understand the roles students may hold. |
| Capital employed | Evaluating investment targets | Capital employed is the total amount of capital used in a firm. It is calculated by subtracting current liabilities from net assets (or, conversely, by adding working capital accounts to fixed assets). | Capital employed is not commonly taught or discussed, but it can be a useful, conservative measure of resources available to management. Managers have all of the firm’s resources at their disposal, and those resources are funded primarily by banks and investors. However, some of the firm’s assets are already committed to meeting short-term obligations, and are therefore not reflective of the management’s true set of resources. |
| Capital expenditures (CAPEX) | Evaluating investment targets | CAPEX are investments made to acquire or upgrade a long-lived asset (i.e., capital asset) that will provide benefits for more than one year. An asset with more than one year of life is capitalized by dividing its cost over the useful life of the asset and then allocating a portion of its cost to each period’s income statement, rather than charging a single expense in one accounting period. | In financial accounting, CAPEX are considered for their impact on various financial statements such as the *income statement* (via depreciation, amortization, interest payments, and tax), the *balance sheet* (via property, plant, and equipment, as well as depreciation, and debt), and the *statement of cash flows* (via investing cash flows and add-backs of non-cash expenses like depreciation and amortization). CAPEX are often also considered in a budgeting context, where managers must ensure that cash is available to meet spending requirements for major purchases or repairs.  In corporate finance, CAPEX projects are sometimes valued separately for managerial decisions, and are sometimes incorporated into valuation methodologies for external investors, where CAPEX impacts both performance projections and investor sentiment. |

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Capital markets | General investing | From a high level, capital markets refer to the entire ecosystem of services that connect entities seeking funds (e.g., businesses, entrepreneurs) with entities who have funds (e.g., investors, banks). Therefore, all stock markets, such as the Toronto Stock Exchange (TSX) or the New York Stock Exchange (NYSE) are part of the capital markets. Stock exchanges are debt and commodity markets. Although the core function of the capital markets is typically related to matching investors with investment opportunities (e.g., raising capital), there are many additional supporting services that improve the efficiency of fundraising transactions such as research departments, trading services, and investment banking or advisory services. | All businesses need money to operate. Even self-funded businesses sometimes need to raise money to expand, acquire assets, diversify risk, or to achieve a certain financial structure. By bringing many investors and fundraisers together, capital markets enable different investors and fundraisers to find an ideal match. Fundraisers can locate funds more frugally, because they can interact with many investors, and locate smarter funds by interacting with investors who specialize in the same industry, for example. |
| Capital structure | Evaluating investment targets | Capital structure reflects the proportion of a company’s funds raised via debt (borrowed from banks) relative to equity (raised from investors). Capital structure is often measured using financial leverage and the debt-to-equity ratio. | One of the most fundamental decisions in corporate finance is the choice of whether funds should be raised from banks (i.e., debt) or investors (i.e., equity). Debt tends to be cheaper, but offers less flexibility because payments must be made every period, irrespective of profitability. It may also be available only in limited amounts (e.g., limited by collateral). Additionally, interest payments on debt are tax deductible, whereas return paid to investors is taxable. |
| Capital asset pricing measuring (CAPM) | General investing | CAPM is now the academic foundation for most risk–return decisions. The model assumes that investment returns are a premium over riskless return (Rf), and that returns are increasing in risk. Risk is modelled as a multiplier (β) on average returns in the market (Rm), which can be thought of as systemic risk. Therefore, investors preferring less risk would seek investments with lower β, and would expect lower return. | This model is important because it is foundational. Students studying finance will discuss this term in their classes. Students in non-finance fields should understand some basic aspects of how to access capital more frugally (e.g., by lowering beta or risk). Those interested in pursuing banking careers also need some fluency with the model (and its assumptions and shortcomings). |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Controlling interest | Evaluating investment targets | For legal purposes, interest in a company (or asset) is the legal control one has over decisions regarding the entity. A shareholder who owns more than 50 per cent of the outstanding shares with voting rights (i.e., equity) of a business has controlling interest, for legal purposes. If some shares do not have voting rights, controlling interest can be achieved with less than 50 per cent of all outstanding shares. | Broadly, one type of risk that investors face relates to uncertainty about management’s strategic choices and/or waste. All shareholders can contribute to the governance and leadership of a company via voting. However, controlling shareholders have the ability to hire and fire executives unilaterally, and thus have the implicit ability to make many strategic decisions on their own.  Specific to financial reporting, interests (controlling and minority) are accounted for differently in financial statements of parent companies. When a company has a controlling interest over another company, it must consolidatethe financial reports by jointly reporting the two entities. |
| Cost of debt | Evaluating investment targets | Cost of debt is the interest rate that a company pays on its debt (i.e., the money it borrows from banks), usually reflected as a percentage. Cost of debt can be calculated on aggregate, for all of a company’s debt, and for different types of debt separately (e.g., short-term, long-term, etc.). | Similar to the weighted-average cost of capital (see Weighted-average cost of capital), cost of debt is typically used to approximate the cost of borrowing additional debt when evaluating new projects. It is also used by external investors to evaluate the financial competence of a company’s management. |
| Cost of equity | Evaluating investment targets | Cost of equity is the required rate of return that a company is expected to pay on its equity capital (i.e., the money it raised from investors), usually reflected as a percentage. For firms with multiple classes of equity (e.g., preferred, common, etc.), cost of equity can be calculated on aggregate, for all of a company’s equity, and separately for different types of equity. | Similar to the weighted-average cost of capital (see Weighted-average cost of capital), cost of equity is typically used to approximate the cost of raising additional capital from equity offerings when evaluating new projects. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Cost of funds | Evaluating investment targets | Generally, the term cost of funds is used to describe the cost of raising money, such as interest on debt, or the required rate of return on equity issuances. Cost of funds is somewhat broad, and can refer to any type of funds. | In financial accounting, calculating the cost of funds is often required, and may relate to tax consequences or financial reporting consequences of funding options. In finance, cost of funds estimates are used when weighing investment options and to consider financing options that help minimize the cost of funds. |
| Credit markets | General investing | See Debt markets |  |
| Credit rating | General Investing | See Debt rating |  |
| Credit spreads (increasing versus decreasing) | General Investing | In most situations, credit spreads refer to the difference in yields between Treasury bonds (which are very low-risk) and other classes of bonds with higher risk. An increasing credit spread implies one or both of the following trends: investors perceive the risk in the non-Treasury bond to be increasing, or investors perceive demand for risky investments to be decreasing (i.e., increasing the price that investors charge for risk). A decrease in credit spread indicates the opposite: risk of the non-Treasury securities is lower or funds have become more available.  More generally, the term “spread” refers to the difference in value between two comparable securities; a credit spread refers to the difference in yield on two bonds. In a sense, it reflects the price of either of two factors: different levels of risk (for bonds with the same maturity but different risk) or the price of different time lengths (for bonds with different maturities but from the same issuer, and thus the same risk). Higher credit spreads indicate that issuers have to pay more interest to find investors for their bonds. | Understanding what a spread is and why spreads widen (i.e., increase) and contract (i.e., decrease) is important when understanding the overall health of the market (e.g., risk, yield, and credit analysis). Credit spreads are often considered leading indicators of market swings—the proverbial “canary in the coal mine” analogy. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Cumulative dividend rates | Evaluating investment targets | Cumulative dividends are shareholder payments that are contractually guaranteed—they cannot be withheld legally, even if company performance drops. Cumulative dividends are typically associated with preferred stock. | Investors expect to receive some type of returnon their investments, which can take many forms (e.g., share buybacks, dividends, etc.). When comparing different investment opportunities, it is important to understand the various return and repayment features, especially those affecting the investments’ risk and return. In this case, by forcing dividends to be distributed, investors are limiting the ability of managers to reinvest capital into the firm (thereby potentially lowering return), but are also limiting the ability of managers to withhold payments in the future (thereby potentially lowering risk). |
| Current ratio | Evaluating investment targets | The current ratio is calculated by dividing current assets by current liabilities, as follows: | The current ratio is generally used as a measure of a company’s ability to meet short-term obligations (i.e., current liabilities) with its short-term resources (i.e., current assets). Companies are generally expected to have more short-term resources than short-term obligations, because a company that cannot meet short-term obligations is illiquid, which can trigger default and possibly bankruptcy. Lenders monitor current ratio closely, because new lending will create additional interest payment, which burdens the company. Lenders typically calculate the current ratio for a borrower twice—once for the borrower’s current financial state and later to consider the impact of any new borrowing. Lenders often also calculate a borrower’s quick ratio (see Quick ratio), which focuses only on *liquid* short-term assets. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Debt-to-equity ratio | Evaluating investment targets | The debt-to-equity ratio is, simply, the ratio of a firm’s total debt capital to its total equity capital, calculated as follows: | The debt-to-equity ratio is a measure of a firm’s capital structure (see Capital structure). It offers some information regarding a firm’s debt burden, cost of capital, and financial flexibility. Typically, it is compared to prior year ratios or to the debt-to-equity ratio of industry peers. |
| Debt markets | General investing | Debt markets are a subset of the capital markets, where debt securities (typically bonds) are issued and openly traded. Governments and large corporations are the primary issuers of debt securities—they are borrowers who raise money in large enough amounts that it is impractical to borrow from a single bank. Bonds and other debt securities are referred to as fixed income securities because they generate fixed periodic payments (e.g., loan payments). Banks invest heavily in fixed income securities, which enable them to diversify their lending by buying bonds from several different borrowers. | Bonds are important to both corporations and banks More capital is raised in debt markets than in equity markets. That is, in the capital market ecosystem, most investments are bond investments. Students should have a basic knowledge of bonds (including pricing, warrants, covenants, trading, interest payments, etc.), which are central to the finance curriculum. Most students can benefit from some understanding of bonds. Students interested in the trading side of finance should have a sharp understanding of bonds. |
| Debt rating | Evaluating investment targets | Debt ratings (e.g., AAA, AA, BBB, etc.) typically refer to ratings issued by credit agencies such as Moody’s and Standard & Poor’s. When the rating evaluates a specific bond, it is a debt rating; when it evaluates a borrower or a bond issuer, it is a credit rating. Agencies determine ratings based on an assessment of the borrower’s ability to repay debts or loans, and are usually derived from a track record and the company’s operating and financial health. | Companies and governments issue debt securities in which investors and creditors demand a certain level of return (in the form of interest) based on the perceived risk, where credit ratings are one estimate of perceived risk. Issuers with higher credit ratings are perceived to be lower risk, and are thus able to borrow at lower interest rates. Issuers with lower credit ratings are perceived to be higher risk and thus must borrow at higher interest rates. Moody’s and Standard & Poor’s are the two of most well-known and trusted independent rating agencies. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Debt ratio | Evaluating investment targets | Debt ratio is calculated by dividing total liabilities by total assets, as follows: | The debt ratio is reflective of a company’s financial leverage. It is useful to determine approximately how much of a company’s assets are funded by lenders (i.e., debt) rather than by investors (i.e., equity). It is also useful for understanding how exposed a company is to economic or financial swings. Because debt payments are contractually fixed, highly leveraged firms can become insolvent or bankrupt if profitability lowers due to company, industry, or macroeconomic factors. Typically, debt ratios are viewed in comparison to peer firms. |
| Discounted cash-flow model (DCF) | Evaluating investment targets | A DCF is a model used to derive the price that you would be willing to pay for an investment (often, a company’s stock). Intuitively, it reflects all of the future cash flows you expect to receive, adjusted (discounted) for the fact that they occur in the future. Simple DCF models can be created based on recent performance trends; more advanced models attempt to account for the effects of present and future decisions even before results are reported and/or forecasting changes to different inputs and assumptions. | DCF models are commonplace in investing. Research analysts, investment bankers, consultants, and accountants all use DCF models regularly. It is important to understand how companies are valued so that you are able to make knowledgeable investment decisions and/or understand the decisions of those investing on your behalf.  Most DCFs used to value stock price forecast yearly cash flows for the first 5 or 10 years because annual results can be plausibly estimated a few years into the future. A “terminal value” is then used to forecast all of the remaining future years based on a simple assumption, because it becomes implausible to estimate annual differences that occur too far in the future. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| DuPont decomposition | Evaluating investment targets | The DuPont decomposition breaks return on assets (i.e., net profit divided by net assets) into two parts: profit margin (calculated by dividing net profit by total sales) multiplied by asset turnover (calculated by dividing total sales by net assets).  It can also be used to break return on equity (calculated by dividing net profit by total equity) into three parts: the decomposition noted above (i.e., profit margin times asset turnover) multiplied also by the equity multiplier (calculated by dividing net assets by total equity), as follows: | The DuPont decomposition helps investors understand howan investment target achieves its return on assets or return on equity. This is important because some sources of return are more enduring or less risky than others. For example, asset turnover is often a reflection of operating efficiency, thought to be an enduring source of competitive advantage, whereas profit margin is often a reflection of pricing premiums (which can be difficult to maintain in the face of competition). A company’s equity multiplier is a reflection of financial leverage, where financial leverage generally increases the returns to shareholders of profitable firms, but also increases the risk that a firm becomes unprofitable in periods of company, industry, or macroeconomic volatility. |

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| Earnings before interest and taxes (EBIT) | Evaluating investment targets | EBIT is found on the income statement, usually as operating profit. However, investment analysts often make adjustments to operating profit on a company-by-company basis. EBIT is a summary profit measure calculated aftersubtracting cost of goods sold, and operating expenses (including depreciation and amortization) from revenue. | EBIT reflects the profitability of a business before considering certain management and temporary costs (e.g., financing, tax, or extraordinary and discontinued operations). From a high level, EBIT is also the maximum amount of interest or financing costs that the company can bear. Similarly, when a borrower defaults, a positive EBIT suggests that the underlying business is healthy, because the interest burden has triggered the default (the business would have been profitable otherwise). But a marginal or negative EBIT suggests that liquidation may be the more prudent option because the business was not profitable even before considering its interest payments. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Earnings before interest, taxes, depreciation, and amortization (EBITDA) | Evaluating investment targets | EBITDA is calculated from the income statement, usually by adding back depreciation and amortization to operating profit. However, investment analysts often make other adjustments to operating profit on a company-by-company basis. EBITDA is a summary measure of profitability, but using a measure that is heavily rooted in cash flows. | EBITDA is a measure of profitability that attempts to remove some accounting distortions by removing two major non-cash expenses that are subject to a significant amount of managerial discretion—depreciation and amortization.  EBITDA differs from operating cash flows on the statement of cash flowsin two primary ways. First, EBITDA does not account for changes in working capital accounts, which can be significant, particularly for growing firms. Second, EBITDA does not account for cash investments in long-lived projects that underlie depreciation and amortization expenses. |
| Earnings per share (EPS) | Evaluating investment targets | EPS is calculated by dividing a company’s net profit by its number of shares. Because most publicly listed companies have various potentially dilutive contracts that could change the number of shares (e.g., stock options), EPS is typically calculated separately for the number of shares currently outstanding, and also for the fully diluted number of shares that *could be* outstanding, if all dilutive contracts were exercised. | EPS is a fundamental measure of firm or investment performance. Investment growth (as a percentage) can be derived from comparing EPS to share price. Because many valuation models are based on versions of projecting profit growth (e.g., price/earnings-to-growth ratio), EPS is a key indicator monitored by investors and investment analysts. |
| Equity paid in (or equity paid up) | Evaluating investment targets | Equity paid in represents the capital actually received by the company when it sells or has sold shares of stock to investors (such as through an initial public offering or a seasoned equity offering). Paid-in capital reflects the number of shares sold multiplied by the price they were originally sold for. Subsequent stock sales between investors do not impact paid-in capital. | Equity paid in is roughly equivalent to the initial investment made in the firm, with retained earnings reflecting the return that the company has generated to date (adjusting for any dividends that have been paid). Equity paid in often figures into analysis based on the company’s financial leverage. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Equity markets | General investing | Equity markets are a subset of the capital markets, where equity securities are issued (through public or private offerings) and openly traded. This market serves as a platform for companies to raise capital from investors in exchange for shares of ownership. Equities tend to be higher risk than debt securities (which should be explained in class), but also tend to offer higher associated returns. Companies that trade stock on public exchanges (e.g., NYSE, NASDAQ, London Stock Exchange, Euronext, or TSX) must comply with many regulations (such as auditing financial statements, filing within a certain time, or publicly disclosing certain information). | Although the value of equities in equity markets is smaller than the value of debt in debt markets, equity markets tend to be better known and are central to the business world. Stock price is an estimate of all of the future cash flows that a firm is expected to generate. Therefore, stock price increases reflect increased expectations of future cash flows (and vice versa). Expectations increases or decreases are often attributed either to managerial choices or macroeconomic conditions. Expectations changes associated with management choices are often attributed to top management—when stock price goes up, management is rewarded; when stock price falls, management is blamed.  Equities are a topic introduced in financial accounting, and are significantly covered in the finance curriculum. It is important to understand the relationship between stock price, valuation, and managerial choice. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Financial leverage | Evaluating investment targets | Financial leverage refers to the proportion of a borrowing firm’s total assets that are funded by debt versus equity—firms that fund more of their assets with debt are considered to be more leveraged. | Companies raise money either from investors, who share in profits, or from banks, who require interest payments. By increasing financial leverage (i.e., increasing debt), investors increase the firm’s resources without increasing their own investment. Financial leverage increases profitability for the firm (and thus, return for investors) if the borrowed money can be invested in a project that returns more than the interest payments required to service the debt. This also increases risk because debt payments do not decrease even if revenues decrease. Generally, the interest rates paid on debt are lower than the rate of return demanded by investors. However, a company that fails to make interest payments is in default on the loans, which triggers bankruptcy. Thus debt capital is generally cheaper but also more risky than equity capital. |
| Financing cash flows | Evaluating investment targets | In the statement of cash flows, financing cash flows is the bottom-most section. This section details cash raised from, or repaid to, investors and lenders or debtholders. | From a high level, the statement of cash flows details how a company’s cash position has changed during the year. Each of its three major sections (i.e., operating, investing, and financing) categorize where cash is coming from and what it is being used for.  Financing cash flows reflect whether a company is, on net, raising new cash externally (if financing cash flows are positive) or paying out cash (if financing cash flows are negative). In growth stages, companies typically raise cash externally to fund internal investments and operations. Mature companies typically generate cash internally to fund investments and operations, and also to pay back external investors and lenders. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Fixed assets ratio | Evaluating investment targets | The fixed assets ratio is calculated by dividing the net fixed assets (which consist of property, plant, and equipment) by the total long-term debt and equity (which is roughly equivalent to the total debt and equity minus current liabilities), as follows: | The fixed asset ratio reflects the balance between long-lived productive fixed assets and long-lived financing sources funding the assets. Generally, investors prefer that the lifespan of assets and funding be matched. It is particularly troubling when long-term financing sources are funding short-term or day-to-day operations (e.g., when the fixed asset ratio becomes very small). |
| Fixed rate loan | General investing | A fixed rate loan, as its name implies, is a debt instrument where the interest payment on the loan is based on a rate that does not change (i.e., the rate is fixed). Many banks offer fixed rate loans across various maturities. | Understanding what a fixed rate is when analyzing a company’s capital structure is important because a company might have several tranches or bundles of debt with different terms. Understanding the rate characteristics of each tranche is vital. |
| Floating rate loan | General investing | A floating rate loan is a debt instrument where the interest rate owed on the loan changes, or floats, based on a benchmark interest rate. Until recently, the most common benchmark interest rate for floating rate loans was the London Interbank Offered Rate (see LIBOR). | In a lower or decreasing interest rate environment, many corporations and individuals opt for a floating rate loan, which tends to reduce the cost of debt. However, borrowers face the risk that rates will increase over the medium and long term. |
| Frozen credit markets | General investing | Generally, credit markets include all places where business can borrow money (i.e., debt and credit), but banks employ a substantial portion of the capital in credit markets. Banks often loan out several times the amount of money they keep on hand. By law, however, they must keep a certain proportion of high-quality funds on hand (known as regulatory capital). If a bank’s estimate of default rates is incorrect or changes (e.g., due to worsening economic conditions), the bank’s ability to issue more loans may be reduced because banks must keep a minimum ratio of regulatory capital to loans. If default rates increase sharply, the bank may be forced to freeze lending because the cash needed to maintain regulatory capital ratios is not received. | All businesses depend on a certain amount of debt or credit, and managers typically plan on debt or credit being available to fund projects or day-to-day business. However, credit markets sometimes freeze, making debt difficult or impossible to obtain. Ironically, frozen markets can become self-reinforcing as otherwise healthy businesses are forced into default or are forced to abandon viable projects because they cannot borrow needed money, leading to an increase in default rates. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Fundamental analysis | Evaluating investment targets | Fundamental analysis is a broad term that relates to the assessment or valuation of a firm based on its financial statements (e.g., cash flow or profitability). | Most initial accounting and finance training is based on fundamental analysis concepts, such as forecasting future profits and future cash flows based on prior profits or cash flows and ratio analysis. |
| Funded debt | Evaluating investment targets | Funded debt refers to long-term, interest-bearing debt. This is debt with a maturity of greater than one year, which includes bonds and loans. | Funded debt comes with interest payments that must be made by the borrower. In the study of financial accounting, students explore how interest payments affect financial statements, learn how to estimate interest consequences of new debt, and learn about the tax implications of interest payments. In the study of finance, students learn how to price debt (typically, as bonds) and examine the impact of funded debt on valuations. |
| Funded debt over EBITDA | Evaluating investment targets | Funded debt is long-term debt (see Funded debt). Funded debt over EBITDA (see EBITDA) is calculated by dividing long-term debt by EBITDA, as follows: | Funded debt over EBITDA is a measure of a company’s ability to pay (approximated with EBITDA) its debt (approximated with long-term debt). |
| Gross block | Evaluating investment targets | Gross block refers to all of a company’s fixed assets (e.g., property, plant, and equipment) *before* accounting for accumulated depreciation. | Gross block is used primarily in manufacturing sectors, which have significant amounts of property, plant, and equipment. Because depreciation methods are both aggressive and differing between companies, using unadjusted figures such as gross block may be helpful when comparing two companies with high property, plant, and equipment costs. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Gross book value | Evaluating investment targets | Gross book value is the value of all of a company’s assets, before accounting for contra-asset accounts that lower assets’ net values over their life. | Gross book value is not commonly used, but can be useful when valuing pledged collateral. Because firms sometimes use aggressive depreciation methods, banks may prefer to apply an alternative method. Separately, gross book value may be helpful when assessing a company’s reinvestment strategy, where companies should be replenishing capital assets at a rate that offsets wear and tear, and strategic lifespan. |
| Hostile takeover | General investing | A hostile takeover is an acquisition method where buyers make an offer to the target company’s shareholders without first negotiating an agreement with the target company’s management team. A primary reason to circumvent target management is because the buyers intend to lay off the management team, often with some intent to significantly restructure and/or sell off portions of the target company (and is thus “hostile” to the present managers). | Companies frequently merge with one another but not all mergers and acquisitions are welcome by existing management. There are numerous examples of buyers making an offer directly to shareholders (e.g., AOL merger with Time Warner, Icahn Enterprise merger with Clorox, etc.). It is important to understand how and why hostile takeovers occur so that you can interpret the significance of hostile takeovers when they occur. Circumvented management teams rarely support this type of acquisition, even when shareholders stand to benefit financially. |
| Interest coverage ratio | Evaluating investment targets | Interest coverage ratio is EBIT (see EBIT) divided by interest payments due in the next year (which can be approximated using interest expense). | The interest coverage ratio is an earnings-based measure (rather than a cash-flow-based measure) of a company’s ability to pay its debt obligations. Generally, it represents the amount of pre-tax profit that is generated by a firm before considering its current interest obligations. A lender typically calculates interest coverage at least twice—once for the borrower’s current financial state, and again after considering any additional debt that the borrower is requesting. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Investing cash flows | Evaluating investment targets | Investing cash flows is the second section in the statement of cash flows. This section details cash generated by and used for infrequent (non-operating) investments. | From a high level, the statement of cash flows documents how a company’s cash position has changed during the year. Each of its three major sections (i.e., operating, investing, and financing) categorizes where cash is coming from and what it is being used for.  The investing cash flow section details spending on long-lived investments (e.g., new aircraft at an airline), as well as any cash generated from terminating or liquidating investments (e.g., disposing of old aircraft or merging with another airline).  In growth stages, investing cash flows are often negative and accelerating; in mature companies, investing cash flows are stable, because new investments offset expiring investments. |

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| Leveraged buyout | General investing | A leveraged buyout occurs when a firm or investor buys a firm primarily with money raised by taking out a loan. The debt increases the buyer’s financial leverage, which is why it is called a leveraged buyout. | Leveraged buyouts enable investors or small groups of investors to purchase large blocks of stock, even if they do not have sufficient resources on their own. Relative to cash or stock purchases, leveraged buyouts add risk to the purchased company because the buyer commits to making interest payments. Consequently, leveraged buyouts are commonly associated with under-valued and mismanaged firms. The firm’s buyers must believe they can generate more efficiencies than the value of the loan payments they will have to make. In the 1980s, some investors (referred to as “corporate raiders”) would initiate leveraged buyouts of undervalued firms that they would immediately liquidate, avoiding the need to make interest payments. |
| London Interbank Offered Rate (LIBOR) | General investing | This is the short-term interest rate that banks charge each other (generally, very low risk loans). Banks often use LIBOR as a reference point when setting interest rates for other borrowers. | From a high level, it is helpful to understand that banks set interest rates for borrowers relative to a baseline. When banks lend money to each another, that rate is often LIBOR. The baseline used when banks lend to businesses or individuals is typically the prime interest rate (see Prime interest rate). |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Line of credit | General investing | (see Operating loan) |  |
| Long-term debt-to-equity ratio | Evaluating investment targets | This ratio is similar to the debt-to-equity ratio, but it includes only long-term debt (i.e., excluding short-term debt). | Short-term and operating capital needs can sometimes skew capital structure measures, particularly for rapidly growing companies (with expanding inventories and wages). Therefore, it can be helpful to look separately at only the long-term components of capital structure (i.e., long-term debt and equity), which may be more revealing of the management’s financing intentions. |
| Market capitalization (or market cap) | Evaluating investment targets | Market cap is an approximation of the total equity value of a company. Market cap is calculated by multiplying the number of outstanding shares by the current share price. The market cap, or equity value of a company, makes up a significant component of the company’s enterprise value (along with debt and cash). | This term is widely used and serves many purposes. Among the most important uses is getting a general sense of the company’s size. Terms like small and large cap are used to categorize companies based on their market cap size on a relative basis.  Market cap gives investors a rough estimate of what other investors believe a company is worth. It is a crude measure in that it multiplies all of a firm’s shares by the current market price, even though many investors hold different valuations (which is why they are not selling shares at current market price). | |
| Mortgage loan | General investing | A mortgage loan is a type of debt financing that individuals and corporations use when they want to buy a house or property. Typically, the individual soliciting the mortgage is required to make a down payment of 10 to 20 per cent of the value of the property. The down payment reduces the bank’s risk in a forced sale of the property, which often generates less than the property’s full value. A forced sale occurs when the borrower defaults on the loan and the property must be liquidated. The mortgage is paid off like most debt, in periodic instalments over the life of the mortgage. | Understanding the mechanics of a mortgage loan is important because most people will take out a mortgage at some point in their lives, and seemingly small differences in mortgage contract terms can result in large differences in the amount ultimately paid. Because houses are expensive, people must choose between saving up for decades to purchase a house with cash, or borrowing money from a bank or comparable financial institution to fund the majority of the purchase price. | |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Operating cash flows | Evaluating investment targets | In the statement of cash flows, operating cash flows is the upper-most section. This section details differences between reported earnings and operating cash flows generated or used by day-to-day operations. | From a high level, the statement of cash flows documents how a company’s cash position has changed during the year. Each of its three major sections (operating, investing, and financing) categorizes where cash is coming from and what it is being used for.  The operating cash flows section serves three main functions. First, it details non-cash expenses that lower net income without imposing cash costs (e.g., depreciation and amortization) that are added back because they are non-cash costs. Second, it details management performance with regard to working capital (e.g., accounts receivable or accounts payable) that does not have a direct impact on income but does affect the cash needs of the business. Third, it corrects for non-operating transactions (e.g., gain on the sale of equipment or a business unit) that affect net income but are reported in the investing section.  A company in the growth stage typically has negative operating cash flows, whereas a company in the mature stage typically has positive operating cash flows. |
| Operating leverage | Evaluating investment targets | Operating leverage refers to the proportion of a company’s costs that are fixed versus variable. Greater proportions of fixed costs are associated with greater operating leverage. | Although the term “leverage” is often associated with debt, it refers to cost structure in this case. For any level of production, fixed costs are typically cheaper but also less flexible than variable costs because managers must commit to fixed costs in advance (i.e., making them fixed). Therefore, managers face a choice between lowering per-unit costs with fixed costs, but with the risk that volume levels may be lower than expected or that technology could advance in the future. |

**GLOSSARY (continued)**

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| **Term,** | **Area of Study** | **What It Is** | **Why It Matters** |
| Operating loan | General investing | An operating loan (also known as a line of credit) is a type of short-term debt instrument intended to cover cash flow gaps or timing differences between when cash must be paid out for projects and when cash is ultimately received. Payments are based on the amount of credit currently used (and not fixed). Operating loans are typically collateralized, which means that they must be guaranteed by an asset of equal value that can be liquidated in case of default. Loans that are fully collateralized typically have lower interest rates. | Many companies take on short-term debt to fund operations, which is typically separated from other debt on the balance sheet. Many companies that sell physical products or have higher inventory amounts take on some form of an operating loan, which is important to analyze. |
| Paid in capital | Evaluating investment targets | (see Equity paid in) |  |
| Payout percentage | Evaluating investment targets | Payout percentage is the proportion of net income that is paid out to shareholders—usually as dividends, but sometimes it may also include share buybacks. | Investment targets must always balance their choice between reinvesting company profits in new projects or paying out profits to shareholders who have other investment opportunities. Payout percentage is useful in conjunction with company life cycle. Growing companies typically have more high-yield internal opportunities, and thus investors expect a low payout percentage because reinvested profits will earn a greater return. Investors will be concerned if a high-growth firm begins paying out a large percentage of profits. However, mature companies typically have fewer high-yield opportunities and suffer from more waste or control issues, so investors expect a higher payout percentage. Investors will be concerned if the company is paying out a small percentage of profits. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Preferred stock | Evaluating investment targets | Preferred stock is a type of equity investment. Typically, preferred stock promises a perpetual dividend, but does not offer voting rights. | Preferred stock has properties of both equity (e.g., perpetually-lived) and debt (e.g., fixed payments and limited voting rights). Preferred stock was more popular historically, when investors had fewer rights and thus preferred firm managers to pay out profits, rather than to reinvest them. |
| Prime interest rate | General investing | The prime interest rate refers to the interest rate that banks charge on loans to their most creditworthy customers. Typically, this rate is set to 3 per cent above the US Treasury bond yield. The prime rate changes when the central bank attempts to increase or decrease its interest rate. | It is important to understand that the interest rate banks charge to borrow funds is based on relative risk (i.e., creditworthiness). The baseline interest rate for most borrowers is called the prime interest rate. The interest rate borrowers ultimately pay will be at (for a few exceptional borrowers) or above (for most typical borrowers) the prime interest rate. |
| Profit after tax (PAT) | Evaluating investment targets | PAT is usually found at or near the bottom of the income statement, sometimes followed by net income from non-controlling interests. | Investors track several different indicators of profitability. The income statement is constructed to calculate many of the different profitability measures that interest investors. PAT is typically among the most important measures of profit. It is the summary measure of total performance of a company for its investors, after considering all of their operational, management, financing, and other decisions. Investors look at other measures of profitability (such as operating profit or EBIT) to understand howmanagers are able to, or failing to, achieve profitability. Ultimately, however, an investor’s own wealth is tied to summary profit. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Quick ratio | Evaluating investment targets | The quick ratio is a measure of a company’s ability to meet short-term obligations with its short-term resources. It is calculated by dividing current assets by current liabilities, as follows: | Even large, well-resourced companies can become insolvent if they are unable to meet near-term obligations. The challenge of staying sufficiently liquid are acute in growing firms, because cash is typically invested months or years in advance of expected returns. |
| Rate of gain (ROG) for sales (as a percentage) | Evaluating investment targets | Rate of gain for sales reflects the annual growth rate for a company’s sales. For a single year, it is calculated by dividing the increase in sales from year 1 to year 2 by sales in year 1. Over multiple years, ROG can be approximated by averaging the ROG for individual years. | Historically, ROG is a concept typically used with livestock, reflecting how much weight livestock adds per day, week, or month. In an investment context, the concept is analogous, but reflecting how much size (as measured by sales revenues) the company is adding each year. Investors commonly assess company growth rates using many valuation models that are conceptually centred on growth. ROG for sales is one of several growth measures available to them. |
| Real estate investment trust (REIT) | General investing | REITs are companies that own, operate, or finance income-producing real estate. A REIT typically comprises one company with many pieces of real estate in its portfolio. To maintain REIT status, the company must pay out nearly all of its residual profits as dividends. Consequently, REITs are also granted pass-through tax status, where profits are taxed only at the investor level, not at the company level. | REITs have several advantages, but can also be very capital intensive. REITs enable smaller investors to capture benefits of real estate investing (e.g., tax advantages or greater liquidity and dividend payouts) without concentrating significant portions of their capital in a single property. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Retail versus institutional investors | General investing | Retail investors are typically individual investors who invest their own personal wealth, whereas institutional investors are typically managers of investment funds or banks that invest funds backed by many investors. Therefore, institutional investors tend to invest considerably more capital, and consequently also tend to have greater resources dedicated to collecting and processing investment information, and to formulating investment strategies. | It is important to understand that different types of investors exist in capital markets. Given the magnitude of capital invested (and the corresponding duty to investors in their fund), institutional investors often employ teams of analysts to help with collecting and processing investment information. Therefore, many students will eventually assume jobs for institutional investors after graduation. However, it is important for all students to understand the structural resource differences facing retail investors compared toinstitutional investors. |
| Return on assets (ROA) | Evaluating investment targets | ROA is calculated as the return (i.e., net profit) divided by the company’s assets (usually, net assets), as follows: | Return on assets is one of the most fundamental performance measures, reflecting a manager’s productivity with the all of the resources s/he has been given (irrespective of financing choices for funding the assets via debt or equity). |
| Return on capital | Evaluating investment targets | (see Return on equity) |  |
| Return on equity (ROE) | Evaluating investment targets | ROE is calculated as the return (i.e., net profit) divided by the company’s total equity (usually, paid-in capital and retained earnings), as follows: | ROE is a performance measure that reflects investor performance after incorporating all management decisions, including financing decisions (i.e., capital structure). It reflects the profit generated by all of the firm’s assets, but compared only against the investment of equity shareholders. The difference between ROA and ROE is related to the amount of financial leverage (i.e., debt) a company has. |
| Sell-side analyst | General investing | (see Buy-side analyst versus sell-side analyst) |  | |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Stock markets | General investing | (see Equity markets) |  |
| Syndicate of multiple lenders | General investing | A syndicate of lenders is a group of institutions or lenders who collectively supply a loan facility to one borrower. Syndicated loans exist because of restrictions on loan sizes that a single bank can extend, proportional to the funds it manages. | This term often appears in news coverage and financial publications when major corporations announce financing. For investors in the financial services sector, it is important to know which banks are in the syndicate because it helps drive bank revenue. Knowing which banks are involved in the syndicate also reflects on the creditworthiness of the project being funded. |
| Term loan | General investing | A term loan is any lending instrument with a fixed amount and fixed repayment schedule. Often, interest rates (and thus, payments) are also fixed. The “term” component indicates that the debt is paid off over the length (or term) of the debt contract in periodic instalments. | Many companies prefer to raise capital by borrowing from banks because it tends to be a lower-cost method of obtaining funds compared to issuing stock, when available. Most financial statements covered in the first year of Ivey’s Honors Business Administration program (HBA 1) make some reference to debt, for which a term loan is one of the most common instruments used. |
| Total debt | Evaluating investment targets | The total debt of a company is equal to the sum of all short-term and long-term debt on a company’s balance sheet. Total debt is often used interchangeably with total liabilities. To calculate debt-to-equity ratios, it is usually appropriate to use total liabilities to represent total debt. However, when calculating cost of debt, it is more precise to remove non-interest-bearing liabilities such as accounts payable and wages payable. | In finance and financial accounting courses, total debt is used frequently when considering financial leverage and when calculating cost of capital. In both courses, numerous types of debt are also discussed. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Turnover versus turnover ratio | Evaluating investment targets | Turnover is synonymous with revenue and refers to the company’s sales in dollars. Turnover ratio (or asset turnover or asset turns) is the ratio of sales divided by total assets. This ratio reflects the sales dollars produced by each dollar of assets. | Turnover (i.e., the measure of revenue) is an indicator of the company’s size, which is important in some valuation assumptions. Turnover ratio (or asset turnover or asset turns) is an indicator of production and operating efficiency. Highly efficient companies require fewer assets to produce the same level of product, all else being equal. To the extent that profit can be decomposed into pricing upcharges and operating efficiencies (see DuPont decomposition), operating efficiencies are thought to be more enduring sources of competitive advantage. |
| Variances | Evaluating investment targets | Variances typically refer to differences between what was budgeted and what was ultimately experienced. Variance analysis is used to understand what caused favourable or unfavourable variances, for accountability purposes and for learning. | Some students may be asked to create variance analysis studies (typically, in cost accounting modules); therefore, all students should be able to recognize and interpret variance analysis output. |
| Weighted-average cost of capital (WACC) | Evaluating investment targets | WACC reflects the real or implied interest payments that the firm pays on the capital it has borrowed—either from investors (i.e., equity) or from banks (i.e., debt). It is calculated by multiplying the interest rate paid on debt by the proportion of capital that is debt (cost of debt), and adding that figure to the required rate of return that investors demand multiplied by the proportion of capital that is equity (cost of equity). | WACC has two main functions. Internally, firm managers use WACC to approximate how much it would cost to raise additional funds when evaluating new projects. Externally, investors use WACC to evaluate the competence of a company’s managers and/or risk preference. Companies with higher WACC compared to peers must defend their reasons for paying more. |

**GLOSSARY (continued)**

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| **Term** | **Area of Study** | **What It Is** | **Why It Matters** |
| Working capital | Evaluating investment targets | Working capital reflects the funds provided by, and needed for, day-to-day operation. Working capital is implicitly provided by suppliers and employees who offer products or perform work in advance of being paid. Working capital is implicitly used by customers and unsold inventory, which cost money but have not yet been converted into cash. Therefore, accounts receivable and inventory both useworking capital. | Working capital is often less visible than other forms of capital because it is not given a separate line on the financial statement. Cash flow timing is critical to the business’s operation. If a business fails to pay lenders, employees, or suppliers, it will find it difficult to continue operating. Depending on the nature and scale of a business, working capital needs can be substantial. |
| Working capital gap | Evaluating investment targets | From a high level, the working capital gap reflects timing differences between when cash is needed to fund work or production at a company, and when cash is ultimately received for services rendered or products sold. The working capital gap can be calculated in three steps. First, convert working capital accounts (e.g., accounts payable, inventory, and accounts receivable) into “days,” by dividing amounts from their corresponding income statement account (e.g., cost of goods sold for accounts payable and inventory; revenue for accounts receivable). Second, subtract the difference between the days when suppliers must be paid (i.e., accounts payable days) and the days when payment is received from customers (i.e., inventory days plus accounts payable days). Third, it is often helpful to convert this amount back into an absolute dollars amount by multiplying the number of days by the estimate of accounts payable dollars in a single day (i.e., cost of goods divided by 365). | When analyzing the efficiency of companies, most companies will show a working capital gap because it is the nature of business to advance costs in the expectation of future sales (and ultimately, cash collections). Working capital gaps are important for two main reasons. First, companies require an operating loan to bridge timing differences between when cash is spent and when cash is ultimately received, which is a potential source of revenue for banks. Second, companies that are cash constrained or facing very high interest payments can often find cash or lower interest payments by reducing the working capital gap (e.g., by collecting cash more quickly or managing inventory better). |

Source: Prepared by the authors.