ACCT 538-01: Financial Statement Analysis (FSA)

Faculty: Carlos A. Mello-e-Souza

Thursday 6:00-8:40 pm ; Lectures in Pigott 102

Office hours: **W** 4:000-5:30 pm; **Th** 4:00-5:30 pm; or by appointment.

Course Description

The objectives of this course are (1) to present a framework for using financial statement data to make investment decisions and (2) to provide hands-on experience using this framework in realistic situations.

I assume that you have a good working knowledge of financial accounting and that you already have, or are in the process of acquiring, a solid understanding of corporate finance. It is also important to be a competent user of a spreadsheet program such as Excel. You should NOT take this course as a substitute for courses on financial accounting such as MBA 503 or ACCT 311/531.

The main difference between this and other courses in accounting and finance is the level of realism and student involvement in class. We will be using real data to make decisions that professional analysts make under time and competitive pressure. The financial analyst is like a detective, looking for hidden value in a mountain of data. To enjoy and be successful in ACCT 538 you should be curious about why stock prices are as they are, about the relationship between financial statement information and stock prices and about what may be hidden between the lines of management's communications with investors. Success is not guaranteed by effort alone, but by effort supported by a solid foundation in financial accounting, along with business sense and the ability to find and integrate multiple pieces of quantitative and non-quantitative information.

The allocation of class time to various topics throughout the quarter reflects the nature of the financial analyst's job: theory-based, dynamic, driven by competitive pressures, and subject to severe data constraints.

- about 90 minutes dedicated to lecture on theoretical aspects and tools or to case discussions (student participation in Q&A expected);
- about 60 minutes for hands-on use of modeling tools (VAPT, eVal, PlayAcct, Excel);

Students with Disabilities

If you have, or think you may have, a disability (including an 'invisible disability' such as a learning disability, a chronic health problem, or a mental health condition) that interferes with your performance as a student in this class, you are encouraged to arrange support services and/or accommodations through Disabilities Services staff in the Learning Center, Loyola 100, (206) 296-5740. Disability-based adjustments to course expectations can be arranged only through this process.

Schedule

A tentative distribution of topics throughout the quarter is attached at the end of this syllabus. Deadlines for assignments are also shown in the schedule. The schedule may be adjusted from time to time as the course progresses due to variations in the time needed to explain each topic. Such changes will be announced by email and in class with sufficient time for you to adjust. I urge you not to fall behind in your readings and assignments! Once you fall behind it is very difficult to recover, since a new topic will be presented almost every time we meet.

My office hours are shown in the heading above. Office hours are a great opportunity for you and I to discuss the course, financial accounting concepts, career choices, or basically any other topic or issue that you think I could help you with. It is best to come to office hours regularly throughout the course rather than just before a critical assignment is due, because at those times many of your classmates will be wanting to see me as well.

Teaching Materials

- REQUIRED

  Equity Valuation and Analysis , 2nd edition, by Lundholm and Sloan (Irwin McGraw-Hill) ISBN 0-07-310026-9.

  Financial Shenanigans, 2nd edition, by Schilit (McGraw-Hill) ISBN 0-07-138626-2.

- OTHER GOOD REFERENCES

  Financial Reporting, Financial Statement Analysis, and Valuation: A Strategic Perspective , 6th edition, by Stickney, Brown and Wahlen (Thomson South-Western)

  The Analysis and Use of Financial Statements, 3rd edition, by White, Sondhi and Fried (Wiley)

  Financial Modeling, 2nd edition, by Beninga (MIT Press.) Chapters 1-4 are directly applicable to the course. Chapters 26, and 29-35 describe useful features of Excel)

  An introductory or intermediate financial accounting text. Example: Kieso, Weygandt and Warfield's Intermediate Accounting.

- RELEVANT RESEARCH PAPERS

1. Nurnberg, H. (1993) "Inconsistencies and Ambiguities in Cash Flow Statements Under FASB Statement No. 95", *Accounting Horizons*, 7 (2): 60-75.
2. Nurnberg, H. and J. A. Largay III (1998) "Interest Payments in Cash Flow Statement", *Accounting Horizons*, 12 (4): 407-418.
3. Ou, J. A. and S. H. Penman (1989) "Financial Statement Analysis and the Prediction of Stock Returns", *Journal of Accounting and Economics*, 11: 295-329.

4. Hillegeist, S. A.; E. K. Keating; and D. P. Cram (2004) "Assessing the Probability of Bankruptcy", *Review of Accounting Studies*, 9: 5-34.
5. Halsey, R. F. (2001) "Using the Residual-Income Stock Price Valuation Model to Teach and Learn Ratio Analysis", *Issues in Accounting Education*, 16 (2): 257-272.
6. Lundholm, R. and T. O'Keefe (2001) "Reconciling Value Estimates from the Discounted Cash Flow Model and the Residual Income Model", *Contemporary Accounting Research*, 18 (2): 311-335.
7. Beneish, M. D. (1999) "The Detection of Earnings Manipulation", *Financial Analysts Journal*, Sep/Oct 1999: 24-36.
8. Bradshaw, M. (2004) "How Do Analysts Use Their Earnings Forecasts in Generating Stock Recommendations", *The Accounting Review*, 79 (1): 25-50.
9. Lie, E. and H. J. Lie (2002) "Multiples Used to Estimate Corporate Value", *Financial Analysts Journal*, Mar/Apr 2002: 44-54.

To obtain copies of these papers:

- Go to Lemieux Library's website; Lemieux Library
- Under "FIND JOURNALS, MAGAZINES, NEWSPAPERS" select "FULL-TEXT ONLINE J. LIST";
- Enter the title of the journal;
- Click on the link;
- Enter your username, password;
- Search for the article;
- Download a pdf copy.

Evaluation

Performance evaluation will be based on: (1) a midterm exam; (2) a ratio analysis report; (3) class participation; (4) homework; and (5) a group analysis and valuation report leading to a buy, sell, or hold recommendation on a publicly traded stock. Relative weights in the final grade are:

Midterm exam	**20%**	(individual)
Ratio analysis report	**20%**	(groups of 2)
Participation	**10%**	(individual)
Homework assignments	**20%**	(individual)
Analysis and valuation report	**30%**	(groups of 4)

An approximate correspondence of final scores with letter grades is as follows:

< 50	> 50	> 60	> 70	> 75	> 85	> 90
F	D	C-,C,C+	B-	B	B+	A-, A

The correspondence is approximate because I wait for significant gaps in the ranked scores before changing letter grades. I also consider the trend in grades and participation in borderline cases. For example, a student with a final score of 89, improving grades over time and good participation may get an A-, whereas a student with a final score of 90, worsening grades over time and poor participation may get a B+.

- The **midterm exam** covers chapters 1 through 6 in the textbook by Lundholm and Sloan. This will be an "open book & open notes" exam, but without access to any type of computer or programmable calculator.
- Class **participation** is indispensable for a good learning experience. Positive participation implies taking on a constructive role in class and in the web-based discussion forum. Examples of positive participation are: coming to class and staying until the end, arriving on time, paying attention, making insightful comments, asking relevant questions, answering questions, and getting actively involved in discussions. Asking an excessive number of questions and/or making comments that do not contribute to the topic under discussion interferes with the learning experience of all students and counts as negative participation. The same holds for any other type of disruptive or disrespectful behavior.
- **Homework** is assigned daily to motivate and guide studying for each lesson. Homework papers will be collected at the beginning of each class. Please bring a second copy to help you participate in class discussions.
- The **ratio analysis report** is for two companies in the same industry, and covers business strategy, risk ratios and return ratios (according to the advanced Dupont framework). Companies should be chosen so that this effort contributes toward the group's analysis and valuation project. For example, if a group has chosen Netflix for the valuation project, its members should do their ratio analysis reports on Netflix, Hollywood, and Blockbuster. (Groups of 2)
- The **analysis and valuation report** leads to a buy, sell, or hold recommendation on the stock of a jointly agreed upon company. (Paper outline and grading rubrics attached.) Your group's written report and oral presentation will be graded on style, originality, diligence in searching for information, and correct use of quantitative techniques. A hard copy of the paper is due by 6 PM on the day of the oral presentations (final exam day). Late papers will not be graded. (Groups of 4)

  Note 1: A company cannot be used for your ratio analysis and valuation reports if: (i) you work there or have access to inside information; (ii) you are now involved, or have been recently involved (less than 12 months ago) in an auditing or consulting engagement with the company; (iii) you have prepared, or are now preparing, a project on business strategy, financial ratios or valuation of that same company for another course at Seattle University. Submitting a report on a company covered by any of the restrictions above violates Seattle University's code of academic honesty and leads to a grade of zero in the project. Please check with me before starting your project if you are not sure whether a company is acceptable.

Note 2: All members of a group must be present in class and actively involved in the class discussion when their group is presenting. Absentee members will receive a zero in the oral presentation component of the grade unless their absence was due to a medical, family or work emergency. (Signed statement from a doctor or supervisor required.)

General rules for assignments

- Part of the grade in every assignment (homework, projects and exams) is related to presentation quality.
- Due dates for assignments are given in the schedule. All assignments must be turned in by the due date in class (in hard-copy format) and on Angel (digital file in the appropriate drop box). Papers cannot be delivered via e-mail or as an e-mail attachment, unless prior permission is given. Late assignments will not be graded.
- Please observe the following guidelines in all your papers:
    (1) put a staple on the top left hand corner of your paper;
    (2) whether typing or handwriting, do so neatly;
    (3) separate one topic/problem from the next, and label each clearly;
    (4) number your pages;
    (5) before stapling verify that all pages are in the right order and that no page is upside down;
    (6) check spelling, grammar and style;
    (7) give credit when quoting the work of others;
    (8) read your paper one last time before handing it in to check the logic of your arguments and also to see whether you really answered the question(s) asked.
- Good written and verbal communication skills are a critical requirement for success in any business endeavor and in any career you may choose to follow, whether in business or not. Remember that your audience (future bosses, customers, etc...) is generally busy, impatient, and WILL choose to read someone else's paper, job application, or business proposal at the very first sign of carelessness. I will not grade papers that reveal carelessness and/or lack of respect for the reader. Papers that are not graded for this reason cannot be resubmitted.

Class Conduct

I expect professional conduct in the classroom at all times. Laptops should be turned off once class begins, unless used for note-taking. Reading of non-class materials should stop once class starts. Cell phones, pagers and any other communication devices should be turned off during class periods and MUST be turned off during exam/project presentation periods. Exception: you may leave a communication device on if you absolutely need to be in touch with someone, but please let me know in advance.

Academic Honesty

I expect that you will abide by the University's Academic Honesty Policy. "Seattle University is committed to the principle that academic honesty and integrity are important values in the educational process. Academic dishonesty in any form is a serious offense against the academic community." Academic Honesty Policy 2004-01

If you are not sure about whether a particular action is acceptable according to the Academic Honesty Code, you should check with me *before* engaging in it.

As required by University regulations I will report the department's chair all verified instances of plagiarism, cheating and usage of unauthorized sources in exams, papers, projects, homework or any other academic assignment. Depending on the severity and circumstances of the violation I may recommend that the student receive a grade of D or F in the course. According to University policy, "a single instance of plagiarism can be the basis for suspension or expulsion from our programs." (Dean Joseph M. Phillips' letter to students, November 2003.)

Online Communications (Angel, Email, Discussion Forum)

Besides in-class and office hour opportunities for communication, I will often communicate with you via Angel and SU email. Please keep in mind that online communications are not meant to substitute for class attendance. Some materials will be distributed *only in class*, and most course-related announcements will be made *only in class*. The fact that you did not receive materials by electronic means is not acceptable as a reason for failing to meet assignment deadlines.

The best way to get in touch with me is via email, but please send email to my Seattle University address, NOT just to the Angel website (if you are using Angel to email, there is a box at the bottom of the screen that needs to be checked so that your message also goes to my regular SU account.) Often I cannot check my telephone answering machine, but I check email several times a day on weekdays. *Do* write to me if you must miss class. *Please include the course title (ACCT 538) in the subject line of your messages to me.* Due to the threat of viruses, I delete without reading messages without a subject, or with a subject that I find suspicious. If regular email stops working, or becomes too slow, I will communicate with the class via Angel.

IMPORTANT: The course's Angel web site has a discussion forum. This forum is for questions related to the content, assignments, grading and conduct of the course. If you wish to ask a question, for example, about how ROA is computed, or about the structure of the ratio analysis project, you should post your question on the discussion forum. ***I will not reply to such questions if they are asked via email.*** The discussion forum has several advantages over email: **(1)** all students get to observe and learn from the exchange; **(2)** I don't need to answer the same question several times; **(3)** someone else may be able to answer your question before I can. I will monitor the discussion periodically and intervene when necessary. Asking and answering questions in the discussion forum contributes to the class participation grade. Of course I will continue to answer questions of a personal nature by email.

ACCT 538 Schedule: Spring 2008

S#	Date	Lecture Topics	Readings and Homework Problems
1	Apr 3	**Introduction** ▪ Overview of FSA & Valuation ▪ Sources of information Introduction to VAPT, eVal, and PlayAcct.	L&S Ch 1, 2 *HW#1: Find a good stock to buy (or sell) today
2	Apr 10	**Assets, Liabilities and Income** ▪ Reading the annual report ▪ Transaction analysis Entering financial statements in VAPT and eVal.	L&S Ch 4 *HW#2: Transaction analysis
3	Apr 17	**Income and Cash** ▪ Life cycle patterns ▪ Accruals and accounting quality Transaction analysis and SoCf preparation with PlayAcct.	L&S Ch 6 (117-131) *HW#3: SoCF
4	Apr 24	**Analysis of Profitability** ▪ The Dupont method ▪ Writing the financial analysis report Profitability of Smith & Wesson	L&S Ch 3, 5 (83-107) *HW#4 : Profitability analysis
5	May 1	**Analysis of Risk** ▪ Analysis of credit risk ▪ Analysis of manipulation risk Risk of Smith & Wesson	L&S Ch 5 (107-115) *HW#5: Risk analysis
6	May 8	Midterm, 6:40-8:40	

S#	Date	Lecture Topics	Readings and Homework Problems
7	May 15	**Forecasting Financial Statements** ▪ Forecasting logic ▪ Worksheet design issues Forecasts for Smith & Wesson	L&S Ch 7, 8 *HW#6: Design a simple forecasting model in Excel Ratio paper due.
8	May 22	**Estimating value** ▪ RIM and DDM ▪ Steady-state; horizon; liquidation Value of Smith & Wesson	L&S Ch 9, 10 *HW#7: Design a simple valuation model in Excel
9	May 29	**Analysis of Accounting Quality** ▪ Qualitative models ▪ Quantitative models Smith & Wesson's accounting quality.	L&S Ch 6 (131-41) *HW#8: Accounting quality analysis
10	Jun 5	**Special Topics in Valuation** ▪ Valuation using multiples ▪ Valuation of distressed firms Sensitivity analysis and other valuation methods applied to Smith & Wesson.	L&S Ch 11 (131-41)
11	Jun 12	Project Presentations (6-8:40 PM)	Valuation paper due.

Links: Academic Calendar ; Final Exam Schedule (TBA)

Important dates:

March 31 (Mon)	Classes Begin
April 6 (Sun)	Last Day to Register, Add/Drop or Change Grading Options
April 24 (Thurs)	University Mission Day Classes that meet 4:30 p.m. or later will meet as scheduled
May 9 (Fri)	Last Day to Withdraw
May 12-14 (Mon-Wed)	Advising: Summer 2008
May 12-16 (Mon-Fri)	Advising: Fall 2008
May 14 (Wed)	Advance Registration Begins: Summer 2008
May 19 (Mon)	Advance Registration Begins: Fall 2008
May 26 (Mon)	Memorial Day: No classes
June 9 (Mon)	Last Class Day
June 10-14 (Tues-Sat)	Final Examinations
June 15 (Sun)	Commencement
June 18 (Wed)	Grades posted on SU Online by 6 p.m.

Outline of the Security Analysis & Valuation Paper

Your term paper on the analysis and valuation of a company should contain the following sections: (1) executive summary; (2) discussion of the company's market, goals, strategies, and environment; (3) ratio-based financial analysis, covering both time-series and cross-sectional comparisons of the key ratios; (4) evaluation of the company's accounting policies and quality of earnings, including the possibility of manipulation, using quantitative and qualitative techniques; (5) assessment of the value of the company's common stock; and (6) a buy, sell or hold recommendation.

The requirements of sections 2-6 are:

> Section 2: *Analyze the company's strategic positioning* within its market, as background for the subsequent ratio analysis, financial planning exercise and valuation. This section lays the foundation for estimating growth rates and sustainable rates of return on assets and equity.
>
> Section 3: *Perform a financial ratio analysis* according to the advanced dupont technique (after restating financial reports for non-productive assets and capital structure.) The dupont analysis must proceed at least to the breakdown of the asset turnover and net profit margin.
>
> Section 4: Before using ratios to build forecasts, it is important to *establish the credibility of published financial reports*. For this you should investigate degree of accounting quality and the possibility of earnings manipulation. In this course we discuss diagnostic tools presented in Lundholm and Sloan (chapter 6.3) and in Beneish's article on the detection of manipulation. (You should apply at least one of these techniques, preferably both.)
>
> Section 5: *Forecast the company's financial statements* (income, balance sheet, cash flows, and changes in shareholders' equity) based on the most recent publicly available information. From the accounting forecasts, *estimate the fair value of your company*. Your report must include a sensitivity analysis of fair value on two or three relevant factors. Also, compare the value obtained with the DCF/RIM models with value obtained using one or more popular multiple techniques. Include in this section a description of the market's expectations about earnings.
>
> Section 6: *A recommendation as to whether investors should buy, sell, or hold* the stock. If you cannot make a recommendation, explain why not.

Deliverables: **(1)** Hard copy of paper; **(2)** executive summary distributed to class before presentation; **(3)** Excel file—eVal or VAPT—in Angel dropbox; **(4)** Word file of paper in Angel dropbox; **(4)** Powerpoint file of presentation in Angel dropbox.

Security Analysis and Valuation Report: Grading Rubrics (*)

	1(↙)	2	3	4	5(↗)	PTS
1. ORAL PRESENTATION						**10**
Oral presentation						
2. WRITTEN PRESENTATION						**30**
Sentence clarity and grace; style						
Editing (spelling, punctuation,…)						
Professional tone						
Document design						
Organization/development						
2. FINANCIAL STATEMENT ANALYSIS						**30**
Link with strategy						
Analysis of return						
Analysis of risk						
Analysis of accounting quality						
Synthesis of ratio analysis						
4. VALUATION						**30**
Quality of forecasting assumptions						
Comparison with market's expectations						
Sensitivity analysis						
Quality of recommendation						

(*) 1=does not meet objective; 3= effective, w/problems; 5=very effective.

Grading: The term paper will be graded on *writing*, *presentation*, *originality*, *diligence in searching for information*, and *correct use of quantitative techniques*.

Report contents and structure: Your term paper on the analysis and valuation of a company should contain the following sections: (1) executive summary; (2) discussion of the company's market, goals, strategies, and environment; (3) ratio-based financial analysis, covering both time-series and cross-sectional comparisons of the key ratios; (4) evaluation of the company's accounting policies and quality of earnings, including the possibility of manipulation, using quantitative and qualitative techniques; (5) assessment of the value of the company's common stock; and (6) a buy, sell or hold recommendation.

Writing Guidelines for Financial Analysts

DO:

- Find the company's story and tell it in a compelling and interesting way. The story can be found in the numbers, in management's explanations for the numbers, and in the market's perceptions about the company. Your job is to find that story and tell it well!
- Assume that the reader is well versed in economics, finance, and accounting. Assume also that the reader is familiar with the analytical tools that you employ.
- Make strong statements supported by the data.
- Use charts and tables when they can help the reader understand an important point. Refer in your write-up to any charts or tables included in the report.
- Try to explain *why* ratios have behaved in a certain way. Saying that "the gross margin has declined *because* the product mix has an increasing percentage of groceries (which are sold at a lower mark-up then general merchandise)" is a useful and interesting explanation. Stating simply that "the gross margin has declined over time" leaves the reader wondering why.
- Make very clear what you mean by saying that a ratio increased by 5%. Do you mean that the ratio increased by 5 percentage *points*, or that the value of the ratio is now 1.05 times what it used to be?
- Write your report so that there is a logical connection between the various ratios, and these ratios lead to well grounded conclusions.
- State conclusions related to your preceding analysis.
- Read and edit your report several times before submitting it. Use the "buddy" system.
- Give credit to all external sources that you draw upon.

DON'T:

- Write your story mechanically as a roller-coaster list of ups and downs about ratios. If that was the job description, computers would have replaced human analysts long ago.
- Make statements that are patently incorrect. A single incorrect statement is all it takes to lose the reader's confidence.
- Make statements that are true by definition, i.e., tautologies. (Example: the profit margin is up because profits increased faster than revenues.)
- Pretend your numbers are more precise than they really are by reporting them with too many decimal places. You lose credibility by doing so.
- Make too many vague statements (indicated by words such as "maybe," "perhaps," or "possibly") that leave the reader wondering whether you truly know what you are writing about.
- State conclusions that are not supported by your preceding analysis.
- Make investment recommendations based on financial ratios alone. (Investment advice must be based on comparisons of market value with estimates of fair value under different scenarios.)

(Ref: Wal-Mart Case by Vidya Awasthi and C. A. Mello-e-Souza, Seattle University)