

Accounting 380K.7 – Summer Term 1 2013.

Financial Statement Analysis

Professor Dr. Patrick Badolato, CPA

Office Hours 4M.252. Time to be determined.

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Course Time/Location M TWTh: GSB 2.122. 11:30-1:30

Teaching Assistants Natalie Masin; Office Hours: to be determined

Our objectives include:

• Increase our understanding of financial filings (including financial statements, managers' commentaries, footnotes and other sources of financial information) in order to:

- o Understand how firms operate and create value
- o Concisely articulate the firm's past—tell the specific story of the firm
- o Increase our understanding and ability to use tools to analyze information presented in financial statements
- o Understand the benefits and limitations of financial information provided in financial filings and the motivation for and process of making adjustments to this information
- Use our understanding of the firm and its financials to make informed predictions about future performance
- o Motivate, understand, construct and implement various inputs in valuation models
- Develop our exposure to making business decisions using financial statement information
- Develop critical thinking skills and practice communicating our decisions using written and oral communication skills

We will review (and learn) accounting concepts as this knowledge is critical to making decisions with financial information. However, the primary objective of the course is *not to improve our understanding* of Generally Accepted Accounting Principles (GAAP); the goal is to improve our ability to interpret and use financial statements in a variety of settings including a primary focus on credit and equity analyses and supplemental coverage of corporate finance, planning and control.

A few notes:

Historically this has been a very challenging class that requires a commitment. It is also a class that provides a ton of current, real and useful knowledge. This is also a class that actively shuns memorization of terms and formulas and the regurgitation of anything. Memorization and regurgitation is not learning, is not useful, and has no place in higher education. In this class, we assume that you will have access to the internet and can always look up formulas or terms, we will not waste your time (and your educational investment) with memorizing, and we will focus on more useful ways of approaching various issues. Therefore, you may hear many "Yes, but..." questions from me: "Yes, but in your own words." "Yes, but why? "Yes, that is the general economic argument, but how has it played out in this scenario?" "Yes, that is the change, but what drove that change? "Yes, but what should we focus on for forecasting in this expected scenario?"

¹ Some of the analyses from class turned out to enable above market returns, but you are not required to make money while you take the class and there can be no guarantee of this same opportunity in the future.

² Some former students suggested that some type of game can be played by keeping track of these comments; I prefer that you follow along in class.

I promise the class will be challenging, but it is also a class that has a straightforward plan for success. Students who truly commit all of the following usually end up with solid grades: (1) consistently preparing for class; (2) being active learners within the classroom and on the Discussion Board and (3) carefully reviewing the material in the 24 hours after class. In a related manner, I encourage group work as this enables you to work together and talk through the assignments both before and after class and discuss each class after class. Each semester students who use the groups to challenge each other usually get high grades. Each semester students choose not to do this and even try to game the system by allocating out the work and never discussing the assignments or class with each other; these student usually end up with lower grades. Each semester students who do not put much effort into the class day to day and instead predominantly resort to cramming, even for multiple days before the exam later realize that this is not an effective way to learn and neither the class nor life provides much of a reward for the ability to memorize and regurgitate. You can choose what is best for you.

In addition:

- 1. By financial statements, we mean "information provided in financial filings and other publicly available sources," which involves more than the Balance Sheet, Income Statement and Statement of Cash Flows.
- 2. This course is not a review of financial accounting. It is expected that you have mastered the material covered during your intro to financial accounting class.
 - a. This class will consistently build off of and apply this knowledge
- 3. This course is not a valuation class. It is a course that helps you use financial information *to better understand the main inputs to valuation models*. This course enables you to move away from an over-reliance or fixation on valuation inputs provided by firms or other analysts and move towards understanding and constructing firm-specific inputs. ... Once we have a set of solid inputs, valuation is simply division and addition.
- 4. This course does not cover technical analysis (analyzing fluctuations in stock prices). If you want to master technical analysis, we recommend that you consider an advanced degree in Physics, Computer Science, Statistics, Behavioral Psychology or a related field in addition to your business studies.

Materials

- **Required text:** The textbook for the course is *Financial Reporting, Financial Statement Analysis and Valuation: A Strategic Perspective* by Wahlen, Baginski and Bradshaw, **seventh edition**.
 - The text provides **our background reading**, so while you need consistent and reliable access to the text and the cases, *you can share the textbook with another student if you are able to work out a plan that ensures sufficient access*. Also, I have two copies for you to access in the two hour reserve at the PCL.
 - o Suggested Text: Accounting for Value by Stephen Penman
 - Excerpts are provided on Blackboard. Anyone who is planning to pursue a career in finance or accounting is encouraged to obtain this book.
- Throughout the course we will be examining publicly available material including corporate press releases, corporate filings (10K's, etc.), analyst reports and articles from the business press. When appropriate, these and other supplemental information (or links to these documents) will be provided via Blackboard. You will be responsible for downloading and printing these articles.
- This semester Hoot.me will take the place of our Blackboard Discussion Board and access to Hoot.me is essential to our class.

Course Structure

The class format involves coverage of the main areas and tools noted below. In addition, there will be a considerable amount of discussions/cases that focus on specific firms and specific financial issues. These cases will involve a careful analysis of the financials, the opportunity to dig deeper to support (or deny) information that is presented, and the consideration of the benefits and limitations of various tools, metrics and ratios.

During the semester we will learn a framework for business analysis and valuation. The steps in the framework include:

- (1) Business Strategy Analysis: The purpose of business strategy analysis is to assess the profit potential of the firm at a qualitative level. This involves an understanding of the firm's strategy and its industry and considering how these affect and are affected by the firm's financial performance.
- (2) Accounting Analysis: The purpose of accounting analysis is to develop an understanding of whether a firm's accounting captures its true underlying economic condition(s). This involves understanding accounting transactions, identifying accounting flexibility, evaluating the appropriateness of accounting policies and estimates, and at times, altering financial statements to enhance decision making.
- (3) Financial Analysis: The purpose of financial analysis is to assess the firm's historical financial performance in the context of its stated goals and strategies. Tools used for financial analysis include ratio analysis, cash flow analysis, and common size financial statements.
- (4) Valuation/Prospective Analysis: The purpose of valuation/prospective analysis is to forecast the firm's future financial performance and valuation. To do this we will learn the mechanics and intricacies of forecasting financial statements and we will cover the components and usage of valuation models.
- The course will be taught using a combination of examples, discussion questions, cases and homework problems. We will learn new concepts using various firms' historical and current financial data.
- A tentative schedule of class meetings is attached to the end of this document. This schedule may be revised.

Quantitative Reasoning

This course carries the Quantitative Reasoning flag. Quantitative Reasoning courses are designed to equip you with skills that are necessary for understanding the types of quantitative arguments you will regularly encounter in your adult and professional life. You should therefore expect a substantial portion of your grade to come from your use of quantitative skills to analyze real-world problems.

Course Requirements and Grading

Your grade in the course will be determined as follows:

Exam 1	25%
Exam 2	40%
Homeworks and Assignments	30%
Course Project	0%
Class Participation	5%
Total	100%

Description of Requirements Exams

There will be two **exams**. Exam 1 will be worth 25% of your course grade. Exam 2 will be worth 40% of your course grade (and is cumulative). The first exam will be held approximately halfway through the semester to ensure students are progressing through the course to date. **The tentative date is Thursday June 20, 2013.** The second exam will be held during finals period and will cover material from *all of the class sessions, with a slightly greater focus on sessions following the first exam.* Please notify me *immediately* if you have a conflict with either of the exam dates once they are posted. All notifications of exam conflicts must be received at least a full week before the exam is scheduled.

Exams are primarily built around class discussions and homeworks and involve your analysis of actual firms' financial information.

Exam (and homework) Re-grades

You have 72 hours from the time that the exam or homework is handed back in which to bring up any re-grades. If we have incorrectly added the points, we can simply recalculate score (for the whole exam). If you are seeking a re-grade on one problem, *the entire exam or homework* is re-graded (and your total points could go down or up). Re-grades cannot be granted after the 72 hour period has lapsed. Requesting re-grades after this period is unprofessional, a violation of this contract, and can result in additional deductions if the specific circumstances are excessively unprofessional.

Course Project

In place of the traditional course project, we will have some of our homeworks geared towards analyzing a specific firm of your choice. For these, each student will be part of a small group. More details about course project will be posted to Blackboard in the Assignments section during the semester.

Homework Assignments

The primary objective of homework assignments is to help you review the class material *before* attending class; many of these constitute the reading for the course as well. You should assume that all homeworks are due before the start of each class, although there are a few explicitly noted exceptions. The assignments will be a combination of computational problems, short answers and cases. There is a set amount of scheduled assignments in total; you are advised to submit <u>ALL</u> of them. However, as I know things come up and prevent you from doing everything on time, you can miss or drop <u>up to two</u> of the homeworks and no reasons need to be provided. A late homework can count as one of your misses or can be turned in within 24 hours for 50% of the total possible points. Students who join the class late can have any missed homeworks count as these dropped homeworks.

This lenient policy is designed to incorporate all valid and unavoidable reasons for turning in late homeworks (for example, students whose textbooks and computers are stolen and whose hotels' internet completely stops working while they are busy saving a litter of puppies from a nearby fire when they are out of town on an interview, which was a once-in-a-lifetime opportunity and had to occur the night before the homework is due) as well as those reasons, which are less valid, such as missing a name, missing a deadline or turning in an incomplete version.

³ Recently I attended a seminar and have read many articles which call this approach a "Flipped Classroom." These noted that a flipped classroom was the new way of approaching education. I have not been in the profession that long, but my initial thought was that this is just a new way to market common-sense, student-focused education.

The homeworks may be completed in small groups. *In fact, I strongly encourage it.* You may choose your own groups and the members may vary from one assignment to the next. Your groups should be 2 to 3 students. You are also responsible for monitoring the groups that you have chosen; if you have any issues, deal with them whenever possible. All group members are also responsible for each assignment: *if all of the names are not clearly listed at the top of the assignment, no group members will get credit; if the assignment is late, no group members will get credit. No exceptions.* You are allowed to work alone if you prefer, but for some of the later homeworks, the questions and length are made assuming students are working in groups. In the past, students have effectively used Skype, Facetime, Google Docs, Dropbox and Comments and Track Changes in Microsoft Word to collaborate from different locations and good, old-fashioned meetings to collaborate in person.

All assignments should be submitted electronically through Blackboard using a program that is compatible with Microsoft Office or Adobe. Some homeworks are graded solely based on effort, while most of the others are graded on the correct completion of the assignment. Many homeworks offer more than one right answer and students can receive a perfect score without having every single answer correct. Homeworks are not all worth the same amount of points. The possible points for each homework will be clearly noted on Blackboard. Please note: for most homeworks you will not get a perfect score if you simply filled out the page without words, but not much thought.

Class participation

Much of class is conducted in a discussion setting. We will not spend much time going over basic computations or mechanics, rather we will analyze specific firms and discuss which metrics are important, the reasons for our approach, and the implications of our choices. The assignments are geared to prepare you to participate in and learn from these discussions. Accordingly, your completion of the assignments and your participation in our discussions are vital. At times, I will only be a facilitator of your discussions with each other. After each class, I will make class participation notes, with particular attention to the quality of comments *or questions*, not the quantity. You do not need to always be correct to participate: insightful questions are also important and I encourage students to answer, even when they are unsure—this is a great way to learn.

Our class will also make use of Discussion Board on Hoot.me in place of Blackboard. This is the forum for outside-of-class questions related to assignments, our class coverage and any related current events. Your Discussion Board involvement can help enhance your class participation grade. Additional Notes:

Class participation provides an opportunity for students to practice important career skills in a low
cost environment. Among other skills, these include the ability to express and defend one's ideas.
(Remember, we may challenge ideas, but we will not challenge people. Rude classroom behavior is
unprofessional and unacceptable.) The cost of not developing these skills will increase as your career
progresses (e.g., lost promotions). I will support any student who gives a solid effort in the
classroom.

Grading Distribution

The following target grade distribution is a general approximation of the possible grades in our class: A (4.0) 25%; A- (3.67) 20%; B+ (3.33) 15%; B (3.0) 35%; B- or below (2.67) 5%. The spirit of this distribution is that it yields a target GPA of 3.42 in each class. A grade of a C- or lower is a failing grade. Cheating is the easiest way to fail the class and any instance will be reported through the appropriate channels. Historically students who choose to not work to their potential self select out of the higher grades.

Grades are determined by summing up all pieces, then ranking all students and then following the class distribution. Some areas of the distribution may be very tight. This means that it is mathematically unavoidable that some students with *similar* grades do not get the *exact same* final letter grades. Ultimately, someone must fall at each "break point" that means that someone gets the lowest of one grade (for example, the lowest A-) and someone else, with similar grades, gets the highest of the next letter grade (for example, the highest B+). The class's historical distribution dictates the percentage of each of the letter grades.

This system coupled with what has historically been a challenging class means that a curve is possible. A curve does not mean that you can blow off the class and get whatever grade you want or got when you were in high school. You are, however, guaranteed the following:

- You will not get lower than letter grade associated with your unadjusted and uncurved raw score according to the traditional uncurved ranges. That is, if you have a raw and unadjusted grade that is > 93, you will get an A.
- The grades will be fair to all students and based on the policies listed above. All grades are checked before they are submitted to the registrar; you do not need to email to ask if I have checked your grade.

McCombs Classroom Professionalism Policy

The University of Texas and the McCombs School of Business are incredible places to learn; let's not take this opportunity for granted. Faculty are expected to be professional and prepared to deliver value for each and every class session. Students are expected to be professional in all respects. The McCombs classroom experience is enhanced when:

- Everyone must arrive on time. On time arrival ensures that classes are able to start and finish at the scheduled time. On time arrival shows respect for both fellow students and faculty and it enhances learning by reducing avoidable distractions.
- Students avoid or minimize unscheduled personal breaks.
- Students are fully prepared for each class. Much of the learning at McCombs takes place during classroom discussions. When students are not prepared they cannot contribute to the overall learning process. This affects not only the individual, but their peers who count on them as well.
- Students attend the class section to which they are registered.
- Students respect the views and opinions of their colleagues. Disagreement and debate are encouraged. Intolerance for the views of others is unacceptable.
- Laptops are not allowed (with the exception of the classes in which we directly use them—these classes will be noted on Blackboard).
- Phones and wireless devices are turned off and there is absolutely no texting during class! You may not have your phone out or in your lap as this is distracting to all of us. A student who reads or sends texts during class disrupts our learning and can receive a 0 for class participation for the semester. If you have a specific personal need to have a cell phone on (for example, waiting to hear back from the Noble Prize Committee or about the birth of your child), you may inform me before class.

Academic Integrity

Don't cheat as (1) it is wrong; (2) the costs <u>far</u> outweigh the benefits: you don't want to get kicked out in a short-sighted attempt to make a B a B+; and (3) there is a very good chance that your cheating will be revealed and we will all be extremely disappointed.

Additional Important Notifications

Students with Disabilities

Students with disabilities may request appropriate academic accommodations from the Division of Diversity and Community Engagement, Services for Students with Disabilities, 512-471-6259, http://www.utexas.edu/diversity/ddce/ssd/.

Religious Holy Days

By UT Austin policy, you must notify me of your pending absence at least fourteen days prior to the date of observance of a religious holy day. If you must miss a class, an examination, a work assignment, or a project in order to observe a religious holy day, you will be given an opportunity to complete the missed work within a reasonable time after the absence.

Policy on Scholastic Dishonesty

The McCombs School of Business has no tolerance for acts of scholastic dishonesty. The responsibilities of both students and faculty with regard to scholastic dishonesty are described in detail in the BBA Program's Statement on Scholastic Dishonesty at

http://www.mccombs.utexas.edu/BBA/Code-of-Ethics.aspx. By teaching this course, I have agreed to observe all faculty responsibilities described in that document. By enrolling in this class, you have agreed to observe all student responsibilities described in that document. If the application of the Statement on Scholastic Dishonesty to this class or its assignments is unclear in any way, it is your responsibility to ask me for clarification. Students who violate University rules on scholastic dishonesty are subject to disciplinary penalties, including the possibility of failure in the course and/or dismissal from the University. Since dishonesty harms the individual, all students, the integrity of the University, and the value of our academic brand, policies on scholastic dishonesty will be strictly enforced. You should refer to the Student Judicial Services website at http://deanofstudents.utexas.edu/sjs/ to access the official University policies and procedures on

http://deanofstudents.utexas.edu/sjs/ to access the official University policies and procedures or scholastic dishonesty as well as further elaboration on what constitutes scholastic dishonesty.

Campus Safety

Please note the following recommendations regarding emergency evacuation from the Office of Campus Safety and Security, 512-471-5767, http://www.utexas.edu/safety:

- Occupants of buildings on The University of Texas at Austin campus are required to evacuate buildings when a fire alarm is activated. Alarm activation or announcement requires exiting and assembling outside.
- Familiarize yourself with all exit doors of each classroom and building you may occupy.
 Remember that the nearest exit door may not be the one you used when entering the building.
- Students requiring assistance in evacuation should inform the instructor in writing during the first week of class.
- In the event of an evacuation, follow the instruction of faculty or class instructors.
- Do not re-enter a building unless given instructions by the following: Austin Fire Department,
 The University of Texas at Austin Police Department, or Fire Prevention Services office.
- Behavior Concerns Advice Line (BCAL): 512-232-5050
- Further information regarding emergency evacuation routes and emergency procedures can be found at: http://www.utexas.edu/emergency.

A schedule will be provided on Blackboard at the start of the semester with specific dates for classes, assignments and exams.