

Financial Statement Analysis

ACC 712 Sections 1 and 2

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INTRODUCTION

Financial Statement analysis (ACC712) provides you with a systematic framework for business analysis and equity valuation using financial statement data, and demonstrates how to apply this framework to a variety of investment, lending, and reporting decisions. The class introduces tools to analyze a firm's financial performance to date, forecast the firm's future performance, and estimate the firm's intrinsic value implied by your forecasts. The course is case-oriented and places heavy emphasis on illustrating the latest techniques and information sources used by Wall Street professionals. The course also integrates recent forecasting and valuation findings from academic research. The student should leave the course with the ability to generate reasonably accurate (or at least logically consistent) forecasts of a firm's future financial performance, including revenues, earnings and free cash flows. The class also presents all the major valuation models in a unified framework so the student should be facile in moving between discounted cash flow models, residual income models and models based on market multiples such as the price-earnings ratio and the market-to-book ratio.

Students are responsible for preparing all cases in advance of the class sessions, including familiarizing themselves with the relevant accounting issues. A564 "Corporate Financial Reporting" is a prerequisite or, as a last resort, a co-requisite for this course. At times the course will draw on your detailed understanding of financial statement data, but more importantly, the course assumes that you understand the nuances of the accounting inputs we will use. Just as it would be possible but dangerous to learn surgery without learning basic medicine, so too would it be possible but dangerous to learn valuation techniques without fully understanding the basic financial statement inputs to the model.

ORGANIZATIONAL DETAILS

1. Course Materials:

The required materials for the course are:

Lundholm and Sloan, *Equity Valuation and Analysis with eVal*, 2nd Edition. McGraw-Hill

Companies. Be sure to get the 2nd edition as it includes the cases; the previous editions do not. It is available at the bookstores or at www.amazon.com but is usually less expensive at www.barnesandnoble.com. *eVal* is a financial spreadsheet application. We will use it extensively, particularly in the second half of the course.

2. Course Evaluation:

Your grade for the course will be determined as follows:

First Mid-Term Exam	20%
Second Mid-Term Exam	20%
Case Write-Ups	25%
Project	25%
Class participation:	10%

The mid-term exams will be given in class on the dates shown in the course outline. I will describe the format of the exams in more detail closer to these dates.

For the case write-ups and project, you are required to self-select into a group of no more than four people. Each group must select and turn in **five** of the cases from the course outline. Please spread your case selections across the major areas on the course outline. Each of these cases will carry a weight of 5%. Case write-ups should be no longer than three typed pages, with no more than three supporting pages of tables or calculations. You will be required to inform me of group membership and case selection during our second session (I will distribute a form for this purpose during our first session). Case write-ups should be turned in at the beginning of the session in which the case is assigned.

The project requirements are explained in more detail on the following pages. Projects are due prior to your presentation. The project grade will be based on the project write-up and a 15-minute presentation to the class at the end of the semester. In addition, each group will be assigned to discuss a different group's project presentation. The class participation grade will be based on your contributions to the class discussions and on your discussion of the other group's project.

Finally, because this is a case course, class participation is expected regardless of whether or not we are covering one of your selected cases. The class participation grade of 10% will be based on your average degree of participation in the class discussion.

3. Office Hours:

My office hours are Wednesday at 4:00 pm or any other time I am in the office.

COURSE OUTLINE

Session 1: 1/8 (Monday)

Course Introduction and Business Strategy Analysis

Reading: *Introduction* Textbook Chapter 1

Information Collection Textbook Chapter 2 (skim only)

Understanding the Business Textbook Chapter 3

Case: Textbook, Boston Chicken, questions 1-3

Session 2: 1/10 (Wednesday)

Accounting Analysis Introduction

Reading: *Accounting Analysis* Textbook Chapter 4

Case: Textbook, Boston Chicken, questions 4-6

1/15: Martin Luther King Day – no class

Session 3: 1/17 (Wednesday)

Expense Recognition

Case: Textbook, Prepaid Legal Services

Session 4: 1/22 (Monday)

Revenue Recognition

Case: Textbook, Overstock.Com

Session 5: 1/24 (Wednesday)

Financial Analysis

Reading: *Ratio Analysis* Textbook Chapter 5

Cash Flow Analysis Textbook Chapter 6

Case: Textbook, Royal Caribbean, part A

Session 6: 1/29 (Monday)

Forecasting long term

Readings: *Structured Forecasting* Textbook Chapter 7

Forecasting Details Textbook Chapter 8

Case: Textbook, Royal Caribbean, part B

Session 7: 1/31 (Wednesday)

Forecasting short term

Reading: *Information Collection* Textbook Chapter 2

Case: Textbook, 'GAAP' versus 'The Street'

Session 8: 2/5 (Monday)

Forecasting really short term

Case: Textbook, The Home Depot, Inc. e-Case

**Session 9: 2/7 (Wednesday)
and Default Prediction**

Reading: *Modeling Credit Risk* Textbook Chapter 5, section 10.

Case: Textbook, A Tale of Two Movie Theaters

**Session 10: 2/12 (Monday)
Midterm I review**

**Session 11: 2/14 (Wednesday)
First Midterm Examination (in class)**

**Session 12: 2/20 (Monday)
Miscellaneous**

Case: Will the Real GE Financial Statements Please Stand Up? (to be distributed in class)

SPRING BREAK!

**Session 13: 3/7 (Wednesday)
Valuation Formulas**

Reading: *The Cost of Capital* Textbook Chapter 9
Valuation Textbook Chapter 10

Case: Textbook, Four Valuation Models, One Value, part A

**Session 14: 3/12 (Monday)
Valuation Formulas Continued**

Case: Textbook, Four Valuation Models, One Value, parts B and C

**Session 15: 3/14 (Wednesday)
Valuing Growth and Profitability**

Case: Textbook, Intel's Earnings Torpedo

**Session 16: 3/19 (Monday)
Valuation Ratios**

Reading: *Valuation Ratios* Textbook Chapter 11

Case: Textbook, The Determinants of Valuation Ratios: The Restaurant Industry in 2003 * In class only – **cannot** be handed in

**Session 17: 3/21 (Wednesday)
Option Value of Equity**

Reading: *Some Complications* Textbook Chapter 12

Case: Textbook, Amazon.Com

Session 18: 3/26 (Monday)

Mergers and Acquisitions

Case: Textbook, The AOL Time Warner Merger

Session 19: 3/28 (Wednesday)

Second Midterm Examination (in class)

Session 20: 4/2 (Monday)

Project Workshop

Session 21: 4/4 (Wednesday)

Project Presentations

Session 22: 4/9 (Monday)

Project Presentations

Session 23: 4/11 (Wednesday)

Project Presentations

Session 24: 4/16 (Monday)

Project Presentations

Description of Group Project Requirements

Objective:

The group project requires you to conduct a complete analysis and valuation of a business. A key feature of the project is that it requires you to identify and obtain the relevant information. Thus, in addition to being evaluated on your ability to apply the tools of analysis described in the course, you will also be evaluated on your ability to identify and obtain the relevant information. Your analysis should provide solid support for the assumptions and forecasts that drive your valuation. (Your valuation should use only publicly available information. Do not use inside information obtained from personal company contacts etc.)

Choosing a Company:

Selecting a company because you like its product or because you plan to work there is unlikely to identify a mis-valued stock. To increase the odds that your analysis will yield a viable investment opportunity, I will provide you with the output of some large-sample stock screens. Common indicators of mis-valued stocks are extreme fundamental-to-price ratios, a lack of consensus in analysts' forecasts, high stock price volatility, high trading volume, a large short position and other similar statistics. The stock screens search for companies that look promising on these dimensions. I will provide you with a list of companies based on these screens near the end of the semester.

Valuation:

Your valuation analysis should follow the steps described in the course.

1. **Business Strategy:** Briefly describe the company's industry and specific lines of business, discuss its strategy for success and, most importantly, the sustainability of profits generated by the strategy. Why do you think the firm's return on equity will or will not revert to its cost of capital? Please do not simply repeat the company overview from the 10K. **(3 points)**
2. **Accounting:** Assess the degree to which the firm's accounting reflects the underlying business reality. Identify accounting distortions and their impact on the sustainability of profits. For instance, R&D is expensed when incurred, but probably creates an economic asset. How will this play out in your forecasts? You may also want to restate or rearrange the existing financial statements to make them easier to forecast. **(3 points)**
3. **Financial Analysis:** Use ratio analysis and/or cash flow analysis to evaluate the current and past performance of the business and assess its sustainability. You should definitely compare your company to some peers in the same industry. **(6 points)**
4. **Forecasting:** Forecast the firm's future income statements and balance sheets. This is the heart of the project so provide specific justification for each major component of your forecasts. Is the forecast based on past trends, comparisons with other firms in the industry, an industry report (such as found at <http://www.netadvantage.standardandpoors.com/> from the library's web page), or your gut feel? How does your forecast for the next few years compare with analyst forecasts? Finding relevant data from outside the firm's own financial statements to guide your forecasts is particularly valuable here, but please only access publicly-available data; do not use inside information that you may have gathered from personal contacts in the company. **(10 points)**
5. **Valuation:** Use either the discounted cash flow or residual income model to produce an estimate of firm value. Focus on the value of a share of common stock in that company and compare your valuation to the market valuation, providing possible explanations for any differences. You may also want to conduct a sensitivity analysis by varying your discount rate and other crucial assumptions. **(3 points)**

Due Date:

Each group will be required to make a 15-minute project presentation during one of our last two sessions. The project is due at the beginning of the session in which your group makes its presentation.

Project Length:

I would like the project write-up to be a readily comprehensible and condensed report of your work (i.e., not a detailed compilation of all the information you collected and all the various valuation scenarios you considered). Accordingly, your write-up is limited to four pages of text and four pages of supporting tables. Please site any sources for data used in your financial analysis or forecasts, such as industry reports.