

Accounting 516

Ram T. S. Ramakrishnan

Financial
Statement
Analysis



2007 Fall



**Course
description**



Schedule



Readings



Notes



**Current Developments
Midterm Examination
Final Examination**

Cases



TAKEDA CHEMICAL INDUSTRIES, LTD.

• Assignment •

NUCOR

• Assignment •



• Assignment •

Coca-Cola Coca-Cola Enterprises

Assignment •

Solutions

Book Problems

Project • Links
• WRDS Notes



• Review for financial accounting prerequisites • Financial Literacy •
• Cartoons • <http://blackboard.uic.edu/>

Accounting & Disclosure after Enron

<http://www.uic.edu/classes/actg/actg516rtr/>

UIC
UNIVERSITY OF ILLINOIS
AT CHICAGO

Department
of Accounting

COLLEGE OF BUSINESS ADMINISTRATION

Accounting 516

Ram T. S. Ramakrishnan

Financial
Statement
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2007 Fall

Instructor: Ram T. S. Ramakrishnan
Office hours: Mondays 1:00-4:00
2300, University Hall; rramakri@uic.edu (312) - 996 - 3270;
Course page: <http://www.uic.edu/classes/actg/actg516tr>



Course description

Required Materials:

The Analysis and Use of Financial Statements, Third Edition Publisher: Wiley;
Gerald I. White, Ashwinpaul C. Sondhi, Dov Fried, ISBN 0-471-37594-2; ©2003
Please bring the textbook and a copy of Pfizer financials (pages 39 to 62) to the class every day.

Wharton Service: <http://wrdsx.wharton.upenn.edu/> [a516fa07; _____]

The recent corporate accountability crises has focused the world's attention on what accounting reports can do and what it can not do. Accounting failures at Enron, WorldCom and numerous other firms has led to extensive reforms in the US. The Sarbanes-Oxley (2002) act includes many accounting and disclosure reforms. But these actions could not prevent the options backdating scandals of 2006-07. Throughout these crises what was surprising was the lack of understanding of GAAP and financial statements by many Board of Directors and Wall Street Analysts. Through this course you will gain a better understanding of some of the issues relating to analyzing financial statements. If one thinks of financial reporting as a game - the executives will try to put the firm in the best light under what GAAP allows, how could you as an analyst disentangle the information.



This course will emphasize the use of published financial reports by decision makers external to the firm (e.g. investors and creditors). Within each decision context, models of valuation and the current state of understanding of empirical research in accounting and finance will be analyzed. Accounting is the "language of business" and with the knowledge gained from this course, you will be able to read, interpret and critically evaluate the published financial disclosures that firms make. You will gain insights into the intense controversies surrounding the promulgation of disclosure standards and you will better understand how you may influence and be influenced by this essentially political process. If you are interested in careers in investment banking, equity research, private equity, risk analysis and in pursuing the CFA designation, this course is a must.

The second major theme of the course is how capital markets react to accounting disclosures. What is (and will be) the value impact of earnings, book value and other accounting information? We will consider the traditional models and also newer insights into the pricing of securities using free cash flows and economic value added. If somebody showed the statements of a firm to you, you should be able to see the "inside" story, ask the right questions and value the firm. The dominant approach in this course will be fundamental analysis. Finally we will survey the empirical results from the capital markets research Bankruptcy and risk prediction models and bond rating models that use accounting numbers will be evaluated. We will look at studies that try to explain variations in the P/E ratios and price to book ratios and earnings response coefficients. Studies that document market anomalies based on accounting numbers will be discussed last.

The standard prerequisites for this course are two courses in financial accounting (for example Accounting 500 and 502). If you have taken only Accounting 500, you may still take this course, if you are willing to put in some extra effort. Please fill the **Prerequisite exemption form**:

<http://accounting.cba.uic.edu/Classes/Prerequisite-Exemption-Form.htm> and bring it to the class to get my approval. The course uses real financial statements extensively and you should be familiar with annual reports. As a part of the course you will be analyzing and valuing one company (a company of your choice) thoroughly. For this, you may have to download 10 - Ks and other SEC filings from 'Disclosure' etc.. **First class**

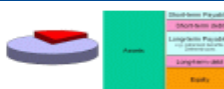
Midterm Examination: 28%; Final Examination: 38%;
Current Developments Discussions 8%; Cases (four out of five) 16%;
Financial statement project: 10%

Course Requirements

Accounting 516

Ram T. S. Ramakrishnan

Financial Statement Analysis



2007 Fall

Session	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	Exam
Date	8/27	9/7	9/10	9/17	9/24	10/1	10/8	10/15	10/22	10/29	11/5	11/12	11/19	11/26	12/3	12/10
Day	Mon	Fri	Mon	Mon	Mon	Mon	Mon	Mon	Mon	Mon	Mon	Mon	Mon	Mon	Mon	Mon

Sessions are as denoted in the description below. All sessions may not have assigned dates.

1 Introduction

Reading: Chapter 1, Notes , First Day Assignments, 2

2 Financial statements: The raw data of analysis; Accrual concept of income; Analysis of cash flow information.

Reading: • Chapters 2 and 3 • Ignore: Nonrecurring items (p. 52-61);
Notes • 03-Lucent-1999-10K-Valuation • Lucent-1999 • Lucent-2000 Financials • Lucent-2000-CF

Class discussion: • 3-4 • 3-10; Homework: • 3-09 • 3-12 • 03-01,02,03,05

Cash Flow Readings

Altria Ready to Consider Next Breakup [Q]

Altria sets terms for Kraft plan 701

An interview with Microsoft's CFO - McKinsey Quarterly

Buybacks Lag, Squeeze Looms For Earnings [Q]

Cigarette-lawsuits-light-up-Kraft-spin-off-talk

Corporate Cash - Use It Or Lose It

Dividend Stocks Haven't Caught Investors' Fancy

Dividends, Buybacks Set New Benchmark for Largess As Corporate Coffers Swell, Holders Reap the Rewards

Dividends-Show-Us-The-Money-Fortune

Firms Ponder What Constitutes Cash

Georgia Tech Crew's Report Spurs Change in Accounting For Operating Cash Flow [Q]

GM Board Seeks Probe of Mistakes In Bookkeeping

GM Expects to Continue Burning Cash [Q]

Ignored Money Waiting to Be Spent

Nalco awash in debt as returns flow to buyers

Now GM Has Woes on Audits

Options Rule Could Hit Cash Flows

Outside Audit- 'Cash Flow Never Lies' -- Or Does It?

Steve Jobs' Bonus

Stock Options Pad Cash Flow Of Soaring Technology Issues

Stocks End Flat, Microsoft Lifts Techs

Surge in Stock Dividends

Too Much Cash

Voluntary Disclosure of Free Cash Flow

Why The Flurry Of Buybacks

Where Accounting Meets Language

DUE 01 Cash Flow Issues Discussion Questions

Current Developments

3 Foundations of Ratio and Financial Analysis; Common size statements; Categories of ratios; Integrated ratio analysis. Earnings per share; Alternate capital structures.

Reading: Chapter 4 • Notes • Financial Analysis of Pfizer • Dell 04 10K (Look at Cash Cycle in page 22)



Schedule

Class discussion: • 04-07 & 08 • 04-20 & 21; Homework: 4-Rest

4 Analysis of inventories: Impact of change in prices; Alternative methods of computing cost; Adjustments from LIFO to FIFO; Financial ratio effect; Reporting and measurement issues; Empirical perspectives; Market reactions to method changes; Is a change to LIFO good news or bad news?

Reading: Chapter 6 • Notes • IRS Rules • IRS Court cases • Form 970

Class discussion: 06-08 & 09; Homework: • 06-01 to 04 • 06-rest

Inventory Readings

<http://www.lifopro.com/index.html>

Big Oil's Accounting Methods Fuel Criticism

Republicans Drop a Tax Plan After Businesses Protest

The Battle to Preserve LIFO - CFO.com

Will Congress Sink LIFO? - CFO.com

DUE 1 Integrated Analysis • Pfizer • Roche • Takeda

Case

5 Capitalization versus Expensing: Acquiring the asset: The capitalization decision; Capitalization of interest costs; Intangible assets Analysis of Long Lived Assets

Reading: • Chapter 7 • Ignore Asset Revaluation and Regulated Utilities p. 240-242

• Chapter 8 • Ignore Impairment of Long Lived assets and Impairment p. 275-282

• Long lived assets notes • Long lived assets example • Estimation notes 1 • Estimation notes 2

Class discussion: 07-09 (Pfizer) • 8-14; Homework: • 07-01, 07, 12 • 07-rest • 8-5 to 10

Long term assets and value Readings

Brand Values 2006 • 2005 • 2004 • 2003

Hidden assets 506

Napoleon's march

Read the Fine Print

The Power of Earnings Power - Barrons September 12, 2005

Value-Accenture.pdf

Will Fair Value Fly? - CFO.com

WorldCom Ex-Finance Chief Says He Told CEO of Accounting Issues Feb 9 2005

6 Income taxes

Deferred taxed; effective tax rate; analysis of tax footnote disclosures; permanent and temporary tax differences.

Reading: • Chapter 9 • Income tax notes

Class discussion: Tax disclosures of Pfizer • Tax related disclosures in GE statements • Look for deferred tax assets and tax related disclosures in Amazon statements • Amazon Taxes

Homework: 9-6, 7, 10, 12, 14

DUE 2 Inventory Analysis of Nucor • Nucor 10-K

Case

Taxes Readings - §

05 Campbell Reports First Quarter Results

706 Lifting the Veil on Tax Risk [Q]

Amazon-4Q-2004 - Look at the news item and tax disclosures (page 16)

Amazon Squeezed by Online Rivals - WSJ 2005

Amazon-4Q-2005

Amazon's Earnings Tumble 43% Revenue Misses Estimates Feb 2006

Comparisons of the tax liabilities of FCCs and USCC - GAO

Corporate Income Taxes In The 90's - Institute on Taxation and Economic Policy

Excise Taxes Muddy Comparisons 2004

Fin-46-PWC

GE Report Raises Doubts
How Accounting Issue Crept Up On Fannie's Pugnacious Chief
How Big Tax Shelter With Cities Shortchanges Federal Treasury
KPMG Used Its Own Tax Shelter
KPMG-Fraud-Survey.pdf
KPMG's Knight in Shining Armor
Minding the Gap [Q]
Pension Fund Was Sold on KPMG
Tax Shelters: Exotic or Just Plain Illegal? - Knowledge@Wharton
Tax Breaks for Executives Who Earn Now, Pay Later
Taxes round the world, Fortune 2003
SEC to Mull Letting U.S. Companies Use Accounting Rules
The Corporate Tax Game, March 2003

7 Analysis of financing liabilities: Long term debt; debt with equity features; effects of changes in interest rate; retirement of debt; Bond covenants; accounting based constraints; Leases and incentives, financial reporting for leases; Off-balance sheet activities.

Reading: Chapter 10, Chapter 11 (Ignore: Appendix 11) Notes

Class discussion: 10-23; Off-balance-sheet activities and Lease notes

Look at lease disclosures in: Sears 1999 • J C Penney 1999 • 11-19 to 22 Sears

Off balance Sheet Readings

Disney-Take-Losses-in-France-March 26, 2004

Enron Aside, Special Purpose Vehicles (SPVs) Are Legal, Innovative and Widely Used - Knowledge@Wharton

Equipment Leasing Association Weighs in on PBS Television Show Frontline's "Tax Me If You Can"

Fin-46-PriceWaterhouseCoppers

Gone Flat

How Big Tax Shelter With Cities Shortchanges Federal Treasury

How Leases Play A Shadowy Role In Accounting

<http://www.pbs.org/wgbh/pages/frontline/shows/tax/> • Equipment Leasing Association

SEC Seeks Enhanced Disclosure Of Pension and Lease Obligations June 2005

Will FASB Ever Issue Good Lease Accounting Principles?

You May Be Liable For That Lease

Homework: 10-03 & 04; 10-rest; 11-17; 11-Rest

8 Off Balance Sheet Financing Techniques

Class discussion: Review

Watch: Tax me if you can on Frontline

Responses from the leasing industry: ELA Online

9 Mid-term Examination: Open Book and Notes

10 Intercorporate Investments Investment in securities; Analysis of marketable securities; Equity method of accounting; Consolidations and comparison

Reading: Chapter 13; Notes

Class discussion: Marketable Securities Example Part 1 • Part 2 • 13-13 Fill-in Form ExxonMobil • 13-13 ExxonMobil

Homework: 13-16 Coke segments • 13 Rest

DUE 3 Texaco Assignment • Texaco 1999 Annual Report • Texaco 1999 10-K

Case

11 Business Combinations and Subsidiaries Off-balance sheet activities and avoiding non-consolidation **What happened at Enron?** Notes

Reading: Chapter 14; Notes

The Overleveraged Disneyland: Will Disney Take Losses in France?

DUE 2 Worldcom

Current Developments

12 Accounting Based Measures of Risk

Prediction of Bankruptcy; the Prediction of Debt Risk and Equity Risk; Debt ratings and covenants; Cost of debt prediction using accounting variables

Reading: Chapter 18, Notes • S&P Corporate criteria (115 pages - not everything!) • S&P ratings (7 pages) • S&P Rating methodology (35 pages) • Altman Paper: Revisiting the Z-score and Zeta® models • 18 Appendix

Class discussion: 18-1 to 3, 18-4 Coke; Homework: 18 -0 5 to 07; 18-08 to 10

Debt Analysis and Bond ratings Readings

Altman Paper: Revisiting the Z-score and Zeta® models

Municipal-Bond Fans Get a Rude Awakening

Rates and Ratings

Credit-card-quiz

Credit-Spreads

CreditStats Final Adjusted Key U.S. Industrial Financial Ratios

CreditStats: Operating Lease Analytical Model

CreditStats: Adjusted Key U.S. Industrial Financial Ratios 2004

CreditStats: Adjusted Key U.S. Industrial Financial Ratios 2003

Hunting the Nearly Extinct 'AAA' May 10 2005

Junk Turns Golden, But May Be Laced With Tinsel 7

Losing Money by Buying Stock Back

Debt management

707 Ratings Cuts By S&P, Moody's Rattle Investors [Q]

706 Debt and the Corporate Tax Base

706 In Emerging Markets, Fewer Debt Covenants [Q]

706 IBM to Spend \$15 Billion In Expanded Stock Buyback [Q]

702 Debt-Driven Deals Shake Up Holders of Highly Rated Bonds [Q]

702 Bond Boom's Thin Ice [Q]

Debt exposure in 757's wake-November 22, 2004

At Levi Strauss, Dockers Are In [Q]

Corporate-Bond Investors Feel Heat [Q]

Corporate Debt Begins to Worry Bond Investors [Q]

Tribune's Response To News Blues: A Big Buyback

Raters and standards

610 Moody's, S&P Still Hold Advantage

601 Big Bond Rally Isn't in Bonds, But in the Raters January 2006

FAS-150-PWC-Monograph

FASB Agrees to Delay, Clarify Ruling on Writing Down Debt

Moodys: • Moodys rating process • Public Firm Risk Model

Standard & Poors:

• S&P Corporate criteria (200+ pages) • S&P Rating methodology (35 pages) • S&P Ratings and Ratios (7 pages)

Links

DefaultRisk.com

Federal Reserve Board - Interest rates

DUE 4 Coca-Cola and Coca-Cola Enterprises

Case

13 Equity Analysis (Empirical Methods)

Classical Approach; Fundamental Analysis; Market Based Research; Positive Accounting Research.

Reading: Chapter 5 Notes;

Class discussion: 05-08,09; Homework: 05-rest

DUE 3 Senate Investigation of rating agencies in the aftermath of Enron **Current Developments**

- Enron and the credit rating agencies
- Is Enron Overpriced? Mar-05-01-Fortune

Equity Markets Readings - C

705 Documenting the Impact of Hedge Funds on Target Companies

705 U.S. Securities Law - Does 'High Intensity' Enforcement Pay Off

706 Wealth Hazard - Guessing Low On Profit Growth

701 Earnings' Stretch Run [Q]

As Two Economists Debate Markets, The Tide Shifts

Circuit City Highlights Doubts About Analysts [Q]

Do Stocks Have Any Zip Left

IBM shares fall as accounting is scrutinised

Losing Money by Buying Stock Back

Pfizer Plans a Revamp And \$4 Billion in Cost Cuts

Pro Forma Earnings - A Different Recipe

These Days, Detective Skills Are Key

This Manager Keeps His Focus On The Balance Sheet

Valuation of a Business-AICPA

Papers

Debt • Earnings-Guidance • Fundamentals or emotions • Making capital structure support strategy

Measuring long-term performance • Measuring stock market performance •

The right role for multiples in valuation • The value of share buybacks

14 Empirical Analysis II

Reading: Paper-"**Evidence that stock prices...**", by V. L. Bernard and J. K. Thomas • Part 1 • Part 2 • Part 3

Assigned question set for the paper

15 Review

Financial Statement Analysis:

Project reports due; **Presentations**

DUE 4 Pension reporting

Beware-the-Pension-Monster

GM Deal May Foreshadow Future For Cos. With Pension Woes

Current Developments

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Annual reports

Pfizer 2003 (with Pharmacia acquisition)

01 **Introduction:** Notes

03 **Cash Flow Notes Analysis:** Notes • 03-Lucent-1999-10K-Valuation • Lucent-1999 • Lucent-2000 Financials • Lucent-2000-CF • Ford 2003 • Ford 2004

04 **Ratios and Analysis:** Notes • NASDAQ • Financial Analysis of Pfizer • Financial Analysis of Pfizer with stock buyback • Dell 04 10K • Dell 05 10K

06 **Inventory** Notes • IRS Rules • IRS Court cases • Form 970
• <http://www.exxonmobil.com/corporate/> Find XOM LIFO reserves • ExxonMobil-10K-2004

07 **Long lived assets I:** Notes • Long lived assets example • Weyerhaeuser • AOL-TimeWarner 2002 • Calpine • Napoleon • Lucent 1999 10K

08 **Long lived Assets II** • Estimation notes 1 • Estimation notes 2

09 **Income taxes:** Notes • Tax analysis for Pfizer • GE statements • Amazon 2002 Statement • Amazon 2001 FS • Amazon Taxes

11 **Financing liabilities; Leases and incentives; Off-balance sheet activities:** Notes • Look at lease disclosures in: Sears 1999 • J C Penney 1999 • 11-19 to 22 Sears

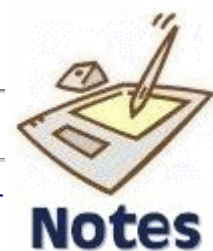
13 **Intercorporate Investments:** Notes • Investments Example Part 1 • Part 2 • With or without ice • Analysis • Book example • Chubb group analysis (from book) • CNA 2005

Enron: Notes •

18 **Risk and Debt analysis:** Notes

05 **Equity Analysis:** Notes • Bernard & Thomas • B&T-Fillin • PPT
• Campbell Reports First Quarter Results (from Company)
• Campbell Soup First-Quarter Profit Climbs 31 Percent on Tax Benefit (from AP)
• SanDisk Shares Drop on Intel-Micron Deal

Nike 06 Announcement • Nike Profit Falls; Marketing Costs, Options Are Cited • Nike Statements • Nike market reaction





Current Developments

01 Cash Flow Issues Discussion Questions

Cash Flow Stops Propping Up Cable Companies' Stock Prices - Jan 09 97 - WSJ

Cash-Flow Crunch Sparks Ford's Desire To Become Smaller and More Focused Oct 8 01 - WSJ

Stock Options Pad Cash Flow Of Soaring Technology Issues - July 17 00 - WSJ

The Ins and Outs of Cash Flow - Jan 22 01 - BW

Up a Creek-with Lots of Cash Jan 22 01 - BW

02 Worldcom Discussion Questions -

1 Securities And Exchange Commission, Plaintiff V Worldcom, Inc, Complaint, Civil Action June 26, 02

2 USA vs Sullivan - Criminal Complaint Aug 01 02

3 Indictment: United States Of America :-V- Scott D. Sullivan And Buford Yates, Jr. Aug 28 02

4 Sullivan Memo

03 Pension reporting Questions

Pensions Readings

A Pension Rule, Sometimes Murky, Is Under Pressure - November 8, 2005

Beware-the-Pension-Monster 03

FASB to Move Pension Accounting - 2006

FASB - New Pension Disclosures

GM Deal May Foreshadow Future June 2003

GM Faces a New Threat to Its Books Dec 2005

Pension Articles Dec 2005

[GM 2003 reports](#)

04 Senate Investigation of rating agencies in the aftermath of Enron

1 Enron and the credit rating agencies

2 Is Enron Overpriced Mar-05-01-Fortune

3 Enron Articles

09 Google - February 2005: Questions

1. Google Press release A

2. Google Press release B

3. Google Net Soars, But Not Enough - Stock Plummets

4. Investors Take a Slap at Google

Analysis 1 • Analysis 2

11 Non-GAAP earnings

[Sarbanes-Oxley-Act](#) - Look at section 401

<http://www.uic.edu/classes/actg/actg516rtr/Readings/Sarbanes-Oxley-Act.pdf>



Financial Statement Analysis - Project

The project has two segments - oral **presentation** and a written **report**. There are two types of topics you can choose from. You can choose a company (or a few companies in an industry) or choose a general topic (e.g. Can merger success be predicted with financial statements?). Your team (upto 4 members) must decide on a topic and tell me by the 3rd class. When you tell me your topic, you must also give me a copy (or send an email copy) of the company's annual report and or the 10-Ks to me. After that, your team must schedule a meeting with me to talk about the issues you will be analyzing. Try to search the financial press (first pass: Fortune, Forbes, Business Week, Wall Street Journal and New York Times) for articles about the firm and email me. When you come to the meeting with me, please bring the basic financial statements, and any articles. At the meeting, we will come up with a set of customized issues and topics that you should focus in your presentation. Some topics are (Note that this list is not comprehensive and you need not include every item on the list)

- 1 ✕ Company Profile; Financial Information and Snapshots of the company
- 2 ✕ Financial Statements; Common size and summary statements;
- 3 ✕ Accounting methods (liberal or conservative); Off balance sheet items; Related party transactions
- 4 ✕ Growth or lack thereof; How did the company finance growth - analyze CFI, CFO and CFF
- 5 ✕ Ratios and comparison with industry (top market caps) and competitors
- 6 ✕ Stock overview, quotes, charts from last few year(s)
- 7 ✕ Risk; Debt and bond ratings; Bankruptcy probability; z-score
- 8 ✕ Key Developments; News from the financial press; Press Releases
- 9 ✕ Market Sentiment; Performance; Shares Shorted; Insider Trading; Institutional Holders
- 10 ✕ Professional Analysis; Earnings Estimates; Your recommendations

Depending on the most interesting issues that arise out of your company choice, I will schedule your group presentation in classes 6 to 15. For example, if debt and borrowing issues are the most important factor for your company, you will be scheduled for presentation in the 7th class. You also need to do a general company written report incorporating all the topics raised in the course. Guidelines are given below and the written report it is due in the last week of the term.

Choosing companies: Choose a company or industry that you may be interested for a career. Please do not choose foreign or financial or real estate firms. Some of the companies that are interesting and the ones that I can help are Chicago companies including Walgreen's, UAL, Sears, McDonalds and Abbott. Other perennial favorites include Gap, AMR, Cisco. Merck, Target, Time-Warner AOL, Maytag, GE and Wal-Mart. You can learn a lot about US capital markets by analyzing the financial statements of these firms.

Presentation guidelines

You must email me the presentation at least 3 hours before class so that I can download it to the classroom. In the class, before the presentation, give a copy of the slides to me. Please restrict yourselves to 10 -15 slides - 10 minutes. Do not show tons of financial ratios and information. Assume that the listener is well informed and make sure that they learn something new and interesting from your presentation. Do not read from a written narrative - you can look at your notes occasionally. You must look at the screen or the class and talk. I will give you a slide clicker and so when you talk you need not be near the computer in the corner. Letter

✕ Click for **Report guidelines**