

Course Information

Title:	Accounting Theory and Paradigms	Semester:	Spring, 2008
Number:	CBA-ACTG 515, code is 26785	Credits:	4
Place:	Room 205, Grand Hall	Times:	Wednesday 6-9pm

Course Professors & Admin

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Course Descriptions for Actg 515

The name of the course, Theory and Paradigms, is a bit of a misnomer, but not completely.¹ The objective of this course is to teach students accounting theory and paradigms through using theory and paradigms, more specifically, by teaching them how to use a financial and accounting information to value firms. We will use what is called "fundamental analysis", which really just means using financial reporting and other economic information to produce pro-forma financial statements (F/S) which are then used to estimate a value for the equity of the firm.

The course will have 15 meetings, 14 lectures/discussion classes and one class with a midterm examination.. The material covered can be loosely divided into four categories. The first three categories cover material that I have presented before. The 4th category is brand new; not only have I never taught it myself, I have never seen it taught by anyone, so we will be breaking new ground here. I describe the four categories as follows.

The first four weeks of classes will cover the Basic Methods in Fundamental Valuation: We will present and discuss three basic valuation methods, the discounted dividends (DDM) discounted cash flow (DCF), and the discounted abnormal earnings (DAE) models. We will concentrate on performing valuations of the firm or entity (i.e. both debt and equity), but will also spend time on the DCF and DAE for equity alone. Each of these methods is based on the discounted dividend model of value, and when correctly applied, each gives the same value. Students will spend this first portion of the course learning how to use each method via Excel spreadsheets. Also, we will discuss the advantages and disadvantages of using each method. The 4th class will relate these models, and especially the DAE model, to valuing firms using multiples. I guess we could call this a 4th method, but I usually do not put it on the same level as the first three... I explain why in the lectures.

The second area of classes, covering the next three meetings or so, will cover Forecasting for Fundamental Valuation. In this second portion of the course, we will explicitly discuss how to go

¹ As you may know, the word paradigm is being used in a special sense. According to Wikipedia.org, [Thomas Kuhn](#) gave this word its contemporary meaning when he adopted it to refer to the set of practices that define a scientific discipline during a particular period of time. Kuhn himself came to prefer the terms [exemplar](#) and [normal science](#), which have more exact philosophical meanings. However, in his book [The Structure of Scientific Revolutions](#) Kuhn defines a scientific paradigm in terms of what is observed, what questions are asked, how they are asked and how the answers are interpreted. Alternatively, the [Oxford English Dictionary](#) defines paradigm as "a pattern or model, an exemplar." Within [normal science](#), the paradigm is the set of exemplary experiments that are likely to be copied or emulated. In this class, paradigm will be used to mean a theoretical model.

about producing a forecast in order to produce pro-forma F/S. We will discuss how to use strategic analysis, statistical analysis and financial analysis to prepare our forecast. However most of our time will be spent discussing accounting analysis for fundamental valuation. Accounting for fundamental valuation involves making adjustments to accounting and financial data to properly employ each of the basic valuation methods. During these classes we will talk about "dirty" versus "clean" surplus items, introduce the distinction between strategic or operating assets and financial assets, and discuss how to create an adjusted set of F/S.

The third area of classes will cover Extensions to Accounting Analysis, with emphasis on Accounting and Earnings Quality. Time permitting, we will discuss how to interpret information from the F/S in deciding on the forecasted amounts, how valuations using multiples compare to valuations using the fundamental approach, and discuss special topics in valuation. In this area, we also cover, among other issues, identifying hidden reserves, distinguishing between aggressive and conservative accounting policies, and issues related to measuring core earnings.

The fourth area is going to be new for me, it is called Special Situation Investing (SSI). As I explain in my lecture notes, the basic approach to fundamental analysis makes a number of assumptions about the firm and the economic situation that do not always hold. In particular, modern value investing involves investing in "special situations" (term used by Graham and Dodd as well as Warren Buffett), which are situations where the assumptions underlying the basic case do not hold. I will build upon the basic case, using the traditional fundamental analysis that we cover in the first three areas of the course as a platform, but we will next cover additional tools and methods for assessing the value of different types of financial claims.

In this fourth section, we will cover techniques and introduce terms that are new (at least I have not seen them in any texts). We will introduce the notions of staying power and how we can "follow the money" to better assess the firm's operational and financial flexibility. We will discuss techniques pulled from fixed income analysis or bond analytics, and discuss how these tools may be used to assess the value of financial claims more generally. The different claims will include debt as well as equity, and should include some possible arbitrage positions or claims related to spin-offs, LBO's, IPO's and other possible investing opportunities. As I mentioned, I have not taught most of the material in this area, but I am looking forward to going through it and developing the course with you. Also, to provide some reassurance, I developed this material with a friend, Mitch Julis, who is a successful hedge fund manager (at Canyon Capital Advisors, LLC, <http://www.canyonpartners.com/>). So, while this material is new to the classroom, we can say it has been tested and passed the test of the real world.

In addition to the course objectives outlined above, I also have two general themes which are a little different and which run throughout all my courses. The first is that there is no "truth" in accounting. One consequence of this theme is that determining whether a financial accounting report is "good" or "bad" requires specifying who is reading the report. The second theme is that accounting measures wealth. One consequence of this is that the essence of financial accounting reduces to tracking the difference between the flow of cash and the flow of wealth; if you can explain the difference then you know just about all there is to know from an accounting standpoint. I will expand on both of these themes in the first lecture.

Course Description (cont.)

The requirements of the course are first, to attend the class meetings. For these meetings, please read the detailed lecture notes for these class meetings (numbered 1 through 9 for now, with more coming... I'll explain in class) and prepare to discuss the problem sets indicated in the detailed course outline provided on the final page of this syllabus. I also provide designated chapters in the Penman book. In the past, I have required the Penman book; I am trying something new this year and specifying the book as recommended instead of requiring.

There is a significant overlap between what I cover and what is covered in the Penman book. My lecture notes are perhaps more directly focused on the lectures and discussions that we will have in each of the class meetings, so from this standpoint, reading my lecture notes may be more cost/time effective. However the Penman book is very well written and has gotten very good reviews from students in previous classes. Regardless, read one, or the other, or both, as long as you internalize the material. (Read this to mean that you may substitute my lecture notes for Steve's book; but beware, in general, I think previous students have preferred the textbook to my lecture notes. This is your call, but you are responsible for the material.)

The lectures/discussions are an important part of the course. As a courtesy to everyone involved in the classroom experience, please observe the following principles:

1. Please be prompt for class and **try not to leave the classroom while class is in session** (unless there is an emergency).
2. Do not carry on private conversations with others during class.
3. Do not bring noisy beepers or cell phones into class, turn them off or put them on silent ring.
4. Use computers only for current class materials; not homework, e-mail, etc.

The required deliverables for the course include a final exam and six problem sets. I will give the final exam on Wednesday, May 7th from 6 to 9 pm (you won't need the entire 3 hours). It covers the lecture material and classroom discussions. The problem sets are graded based on effort. They are used primarily as a teaching tool, not as a way to evaluate your performance. I will not expect the worksheets for the problem sets to be perfect, especially in the first couple weeks of classes. However, you will get much more out of these discussions if you are familiar with the worksheets and the equations. So prepare the worksheets as completely as possible, and come prepared to ask as well as answer questions about them.

The class is structured so that the problem sets are discussed during the class period on which they are due. So, for example, the first problem set is due on Wednesday, January 23rd, the second is due on Wednesday, January 30th, etc. (See Daily Class Outline at the end of this syllabus for the other dates.) Also, while you may discuss the problem sets with your colleagues, I expect you to prepare the worksheet that you submit by yourself, no copying files. Besides the case discussions, which often get abbreviated due to time constraints, we will discuss the preparation of the worksheets in class, especially for the classes in the first three weeks of the course. For these discussions, you will need your laptop, so plan on bringing it each week.

Course Description (cont.)

In addition to the text, the lecture notes and the problem sets, we will be using the annual reports for Kimberly Clark and General Mills extensively, so bring them to class. I will refer to them periodically, but especially later in the course, so plan to have them available. You will need the financial statements and the footnotes. The rest of the report is nice to have, but it is not really necessary for class discussion purposes. I prefer to work from hard (i.e., paper) copies, but you may use the relevant 10K, and may access a soft (i.e., electronic) copy from your computer. Access these either from the SEC website, from the websites of each of the firms, or from whatever source you prefer.

Last, you have an option to prepare a valuation project of your own. I say this is optional, since you do not need it to pass. While not required, you can certainly increase your grade by submitting a project. If you opt for a valuation, I want a paper, 10 pages or less in text, handed in on the last class meeting, which this year means Wednesday, April 30th. (Include the valuation worksheet as an appendix, or submit it via email as a worksheet, so that it will not count in the 10-page limit.) At a minimum, perform a valuation using the DCF and DAE models for the firm as a whole, and include the following:

- a discussion of how the financial statements were reformulated;
- how the forecast was performed;
- any strategic, financial or other analysis that was performed, and
- a discussion of how your valuation compares to the market price of the firm that you are valuing, at the date of the valuation.

I would like you to submit the name of the firm on which you will perform your valuation to me by Wednesday, April 2nd, the Wednesday after spring break. If you have difficulties making this choice, let me know, I will have suggestions. If there are questions about the project or any of the course requirements outlined above, please feel free to contact me. Also, I've taught this course, in various forms, over a dozen times over the last ten years; during this time the course has changed quite a bit, largely based on student suggestions. If you have suggestions for changes in the course as we proceed through the semester, please let me know.

You should refer to the Course Events section below for more details on the material covered. In that section I provide a detailed class outline that specifies the topics we will cover at each session, the chapters and cases in the Penman book that you should prepare for each session, as well as when the problem sets are due.

Acknowledgements: Almost every course depends on more than one person; it is especially true for this course. I would like to thank my current and former colleagues, especially Jake Thomas, Laurie Hodrick, Stephen Penman and Kristen Willard, for their generosity in sharing their time and course notes.

Policies and Requirements

While there are no formal course prerequisites, this course builds on material studied in intermediate courses in accounting, finance and economics. Besides the Penman text, you will need the following required material

- Laptop computer with Excel, Powerpoint and Word software and access to the web.
- Lecture notes and problem sets (in case packet or download from course website).
- Annual reports for Kimberly Clark (for fiscal years ending December 31st, 2006) and for General Mills Inc. (for fiscal years ending May 28th, 2006).

Grading: Grading will be based on the five problem sets, the exams and on an optional final project. Grades are determined as follows:

Participation and problem Sets = 30%, exams = 50%, optional final project = 20%.

I determine course grades by allocating 30% of the total grade to class participation and problem sets (6% to the participation grade and 24% for problem sets), 20% to an **optional** final project and the remaining 50% to the exams. Here is more details on the grading.

Problem sets are graded based on effort. (See my discussion in the Course Description section above.) All problem sets will be based on worksheets which are to be submitted electronically to me (my e-mail is mkirsche@uic.edu) by noon on the appropriate Wednesday. (I require this so that you can ask and answer questions off of your worksheets during the class on that night.) Put “Actg 515 PS” in the subject to direct email to proper folder, and put your name and the PS1, or PS2, etc., to help me sort the emails.

In addition, I require you to take two exams, a midterm and a final. I will allocate the 50% between your two exams using method A or B below, whichever method gives you the highest score. These methods are as follows:

Method A: 25% to Midterm 25% to Final (i.e., half of the 50% to each exam).

Method B: 10% to Midterm 40% to Final (i.e., 1/5 of 50% to midterm, 4/5 to final).

Both exams will be open-book exams and both will be timed (probably 2 hours for each).

Finally, we have an optional final project. I describe the requirements for this project in the **Course Description** section. Clearly, you can pass the course without submitting a final project but it is difficult to get the highest grade if you do not submit a project. Also, while I allow teams of up to 4 people to work on and submit a project, I use a more demanding grading scheme with more people involved. Last, **any queries about grading must be submitted in writing.**

Honor Code Issue: Problem sets assigned as homework can be discussed, in fact, I encourage collaborative work, but solutions submitted by each student should be his or her own individual work.

Textbooks, Cases and Readings

Title:	Financial Statement Analysis and Security Valuation.
Author:	Stephen H. Penman
Edition:	3 rd , (2 nd edition is okay too).
Publisher:	McGraw-Hill Irwin, 2007 (2002)
ISBN:	ISBN-13: 978-0-07-312713-2, ISBN-10: same w/o 978, (2 nd , ed: 0-07-253317-X)
Status:	Required
Type:	3

Title:	The Analysis and Use of Financial Statements.
Author:	Gerald White, Ashwinpaul Sondhi and Dov Fried
Edition:	
Publisher:	John Wiley & Sons, New York, 1994
ISBN:	
Status:	Reference
Type:	

Title:	Business Analysis & Valuation Using Financial Statements.
Author:	Krishna Palepu, Victor Bernard and Paul Healy
Edition:	3 rd
Publisher:	Thomson Southwestern
ISBN:	0-32-4201575
Status:	Reference
Type:	

Title:	Damodaran on Valuation
Author:	Aswath Damodaran
Edition:	
Publisher:	John Wiley & Sons, New York, 1994
ISBN:	
Status:	Reference
Type:	

Title:	Financial Reporting and Statement Analysis: A Strategic Perspective
Author:	Clyde Stickney and Paul Brown
Edition:	
Publisher:	Dryden Press (Harcourt Brace), 1998.Thomson Southwestern
ISBN:	
Status:	Reference
Type:	

Title:	Value Investing: A Balanced Approach
Author:	Martin J. Whitman
Edition:	1 st
Publisher:	John Wiley & Sons, New York, 1999
ISBN:	0-471-39810-1
Status:	Reference
Type:	

Title:	Value Investing: From Graham to Buffett and Beyond
Author:	Bruce C.N. Greenwald, Judd Kahn, Paul D. Sonkin and Michael van Biema
Edition:	1 st
Publisher:	John Wiley & Sons, New York, 2001
ISBN:	0-471-38198-5
Status:	Reference
Type:	

Title:	You Can Be A Stock Market Genius (Even if you're not too smart)
Author:	Joel Greenblatt
Edition:	1 st
Publisher:	Simon & Schuster, New York, 1997
ISBN:	0-684-83213-5
Status:	Reference
Type:	

I have other book suggestions for interested students, just give me a holler.

This summarizes the material covered in Actg 515 and my reasoning behind the design of the course. Next I provide a tentative **Detailed Class Outline**. I call it tentative as we may spend more or less time on individual areas, depending on how quickly or slowly we proceed.

Detailed Class Outline for Accounting Theory and Paradigms – Actg 515:

1st Mtg - Basic Models, Part 1: Introduction

Wed Defining investment returns, the accounting for and measuring of cash flows and the
Jan 16th, dividend discount model (DDM) for equity valuation.

Reading: Actg 515 Lecture Notes #1 (see on-line), Chapters 1-3 in Financial Statement Analysis and Security Valuation by Stephen Penman (3rd edition), henceforth abbreviated as SP. As practice, you may wish to Skim M1.1 AOL.

2nd Mtg - Basic Models, Part 2: DCF

Wed Introduce the discounted cash flow (DCF) model and briefly, discuss the theory and
Jan 23rd, techniques involved in measuring the cost of capital.

Reading: Actg 515 Lecture Notes #2 and Chapter 4 and pages 684 -696 in Chapter 18 on the analysis of equity risk in SP (in the 2nd edition, look at pages 429-432 in chapter 13).

Due: Problem Set #1 (The GAP #1 - Measuring cash flows).

3rd Mtg – Basic Models, Part 3: DAE

Wed Introduce the discounted abnormal earnings (DAE) model, equivalence of DCF and
Jan 30th, DAE models, and discussion of modeling assumptions.

Reading: Actg 515 Lecture Notes #3 and Chapter 5 in SP.

Due: Problem Set #2 (The GAP #2 – Valuation using the DCF model)

4th Mtg – Basic Models part 4: P/e and P/B based models

Wed Define multiples, introduce the price/earnings (P/e) and market to book (P/B) multiples
Feb 6th define normal P/e and P/B multiples and relate these multiples to the DAE model.

Reading: Actg 515 Lecture Notes #4 and Chapters 6 and 13 in SP.

Due: Problem Set #3 (The GAP #3 – Valuation using the DAE model)

5th Mtg – Forecasting Part 1: The big picture

Wed Discuss the four types of analysis, accounting, financial, strategic (or economic), and
Feb 13th statistical analyses, with detailed discussion of the latter two

Reading: Actg 515 Lecture Notes #5 and Chapters 14 and 15 in SP.

6th Mtg – Forecasting Part 2: Accounting analysis

Wed Discuss adjustments to the OE/S (statement of changes in owners' equity), including
Feb 20th, adjustments to correct for dirty surplus items, and discuss how to identify and deal with operating versus financing assets and liabilities.

Reading: Actg 515 Lecture Notes #6 and Chapters 7 and 8 in SP.

Due: Problem Set #4 (The GAP #4 – Valuation using the WACC)

Detailed Class Outline (cont.)

7th Mtg – Forecasting Part 3: Adjusting the F/S

Wed Feb 27th Continue with the discussion of how to perform the accounting analysis and how to adjust the B/S (balance sheet) and I/S (income statement) including distinguishing between operating and financing and deciding what to forecast.

Reading: Actg 515 Lecture Notes #7 and Chapters 9 and 10 in SP.

8th Mtg – Extended Analysis Part 1: Advanced forecasting issues

Wed Finish cost of capacity and, time willing, move into liabilities.

Mar 5th, No readings, practice problems or cases, but review material up to the prior class.

Reading: Actg 515 Lecture Notes #8 and Chapters 11 and 12 in SP.

Due: Problem Set #5 (The GAP #5 – Valuation with sensitivity analysis)

9th Mtg – Extended Analysis Part 2: Quality of accounting

Wed Discuss quality of accounting with emphasis on understanding choices among accounting policies, discuss conservatism and hidden reserves.

Mar 12th,

Reading: Actg 515 Lecture Notes #9 and Chapters 16 and 17 in SP.

10th Mtg, Wednesday, March 19th: **Midterm Exam for Actg 515.**

Monday March 24th to Friday, March 28th, Spring vacation – no classes

11th Mtg – Special Situation Investing (SSI) Part 1: Value investing in the capital structure

Wed Introduce the notion of SSI via reference to traditional value investing. Discuss such issues as margin of safety, valuation using Greenwald's approach to measure replacement value, earnings power and franchise growth value, distinguishing between return on your money and return of your money, and comparing price or value models to return models that focus on disaggregated information.

Apr 2nd,

Reading: Actg 515 Lecture Notes #10.

Due: Problem Set #6 (General Mills valuation).

12th Mtg – SSI Part 2: Follow the money

Wed Introduce the idea that we need to “follow the money” to make sure that we get return of our money as well as return on our money. Show how to use the accounting box to track the cash and reconcile the accruals to the income and cash flows.

Apr 9th,

Reading: Actg 515 Lecture Notes #11.

Cases: TBD.

Detailed Class Outline (cont.)

13th Mtg – SSI, Part 3: Bond analytics

Wed In this section on bond analytics, we introduce Total Return Analysis (TRA), explaining
Apr 16th, how it provides a very different frame for perceiving the investment situation, one that focuses on how we shall cash out, not merely how wealth is created. We also discuss Uniform Credit (or Cash) Analysis, (UCA) and compare it to US GAAP accounting for cash flows..

Reading: Actg 515 Lecture Notes #12 and read Chapter 19 in SP.

Cases: TBD.

14th Mtg – SSI Part 4: Staying power

Wed We introduce the idea of “staying power” or the ability for firm management to ride out
Apr 23rd, difficult economic conditions. The ideas of operational and financial flexibility are stressed, as well as the use of decision analysis, especially the construction and use of decision trees.

Reading: Actg 515 Lecture Notes #13.

Cases: TBD.

15th Mtg – SSI Part 5: Restructurings

Wed, Time permitting, we discuss investing in restructuring situations and the opportunities
Apr 30th, that such situations may offer. We also wrap-up course and review for exam.

Reading: Actg 515 Lecture Notes #14.

Cases: TBD.

16th Mtg, Wednesday, May 7th: **Final Exam for Actg 515**