

ACCT 5300 / FINC 5300: Financial Statement Analysis and Security Valuation

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Class meetings: **M**, 6:00-9:00 pm, **Pigott 200**
Office hours: Mondays from 4:30 until 5:55 pm; *or by appointment*

1. 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. An important difference between this course and other accounting and finance courses you may have taken before is the level of realism. We will be using real data to make decisions that professional analysts make under extreme time and competitive pressures. The financial analyst is like a detective, looking for hidden investment opportunities in a mountain of data.

To enjoy and be successful in ACCT 5300 / FINC 5300 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 integrate multiple pieces of quantitative and non-quantitative information. Other key factors for success will be the ability and/or a strong desire to learn how to be an effective team member, design reliable Excel spreadsheets and communicate well verbally and in writing about technical accounting and financial issues.

2. Learning Objectives

At the end of this course students will be able to:

- Obtain financial information from COMPUSTAT (via WRDS).
- Evaluate a company's performance and financial position using financial ratios.
- Use a financial model to forecast financial statements.
- Use a financial model to estimate the fair value of a business.
- Perform a basic analysis of accounting quality using quantitative models.

- Explain the weaknesses and limitations of financial forecasting models and of the recommendations that can be made based on those models.

This course meets the following among Seattle University's graduate learning outcomes:

- Demonstrate mastery of competencies required in their profession or field.
- Demonstrate effective communication in speech and in writing.
- Exhibit effective collaboration skills.

This course meets the following among the Albers School's Master's in Professional Accounting learning outcomes:

(LO#1) HIGH IMPACT: Recommend a course of action to a prospective client by using a model to analyze financial statements and other relevant data.

(LO#2) HIGH IMPACT: Evaluate the accounting implications of an economic event by applying the principles, standards, and practices of financial accounting.

(LO#3) MEDIUM IMPACT: Advise stakeholders of how strategic business risks relate to financial reporting using archival data.

(LO#5) LOW IMPACT: Construct arguments for and against alternative accounting decisions by weighing the ethical, stakeholder, and stewardship implications of each.

3. Prerequisites

There are two prerequisites for ACCT 5300 / FINC 5300: **ACCT 5110** (Intermediate Financial Accounting) and **FINC 5050** (Corporate Financial Management). I assume that students enrolled in this course have a basic understanding of:

- how financial statements are prepared and how they are interconnected;
- the structure of a typical annual report and where to go to find information in it;
- accounting for a set of common transactions for manufacturing, service, and retail businesses.
- the concept of present value of cash flows, and know how to estimate the fair value of an asset as the present value of a stream of expected cash flows at the appropriate discount rate.

If your memory of these topics has faded, but you have known them well before, you can probably catch-up. But if your knowledge of financial accounting principles is weak or you are

unfamiliar with discounted cash flow techniques and basic managerial finance please come and talk to me as soon as possible. This course may be inappropriate for you now.

4. Materials

Required:

- “Equity Valuation and Analysis with eVal” 3rd ed., by R. Lundholm and R. Sloan (McGraw-Hill Irwin). Website: <http://www.lundholmandsloan.com/index.html>
- Software: Microsoft Excel 2013. (Excel 2010 is fine too.)
- A laptop computer is recommended for every class and is indispensable for taking the exam. If you don’t have a laptop computer, or if it is not convenient for you to bring one to class, please let me know and I will attempt to reserve one for you with the IT group.

Note: If you own an Apple computer I strongly recommend that you run Excel 2013 on Windows or use one of the school’s laptops.

5. Grades

Grades will be based on participation, homework exercises, an exam, and a professional quality group valuation and analysis report leading to a buy, sell, or hold recommendation on a publicly traded stock. Late assignments receive a grade of zero. The relative weights are:

1. Participation 10 %
2. Homework (three items, group) 25 % (attachment I)
3. Exam 35 %
4. Analysis and valuation report (group) 30 % (attachments II, III, IV)

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

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

The following paragraphs provide more detail regarding participation and the term project.

PARTICIPATION IN CLASS DISCUSSIONS

I will measure degree of positive participation by means of attendance and instances in which a student shares interesting news, asks good questions, or answers questions asked in class. The table below shows the correspondence between involvement in class discussions, attendance, and the participation grade:

No. of instances of class involvement		Days of attendance (*)	Participation Grade (**)
≥ 5	AND	≥ 9	100
≥ 5	AND	= 8	95
≥ 3	AND	≥ 8	90
≥ 3	AND	= 7	85
≥ 2	AND	≥ 7	80
≥ 2	AND	= 6	75
≥ 1	AND	≥ 6	70
≥ 1	AND	= 5	60
= 0	AND	≥ 5	50
≥ 0	AND	< 5	0

(*) Attendance is counted if the student arrives no later than 10 minutes after the beginning of class, and leaves no earlier than 10 minutes before the end of class. Attendance will be counted at all scheduled meetings, except the final exam/project presentations date.

(**) The highest grade applies if you meet more than one condition.

Although this is EXTREMELY rare, I have had students in the past who affected the class in a negative way. Negative participation includes instances of non-professional behavior during office hours, in class, during exams or project presentations, and in communications with classmates or the instructor. I will discuss any instance of negative participation as soon as possible after I observe it and will also send the student an email message about it. The first instance of negative participation reduces the participation score by anywhere between 20 and 50 points, depending on severity. The second instance reduces the participation score to zero.

ANALYSIS AND VALUATION REPORT

The analysis and valuation report leads to a buy, sell, or hold recommendation on the stock of a jointly agreed upon company. The paper's outline and grading rubrics are in attachments II and III. A hard copy of the paper and written peer evaluations are due by 6 PM on the day of the oral presentations. The oral presentation cannot be done unless a hardcopy of the paper is delivered in a timely fashion. In addition:

- (1) Every group must analyze a different company.

- (2) Groups will be formed randomly before the end of the second class. If the class size is: (i) an exact multiple of 4, all groups as originally formed will have 4 members; (ii) a multiple of 4 plus N , N groups will have 5 members.
- (3) Your final grade in the term project will reflect the average of your peer's evaluations, combined with my own evaluation of your contribution. For example, if the paper deserves an A, but your contribution on average was rated 2 on a scale of 0 to 4, your grade in this report will be a C. If the paper deserves an A, your peers rate your contribution a 3, but I cannot see or obtain any evidence that you contributed to the project, your grade may still be a C or even a D. If you don't contribute at all, your grade in the project will be zero. As soon as I notice that a student is NOT actively engaged, I will send an email message, and request a one-on-one meeting. *Given the weight of the project in the final grade, it may be better to drop the course than to continue if you cannot contribute to the group project.*
- (4) A company cannot be used in your valuation report 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 financial ratios or valuation of that same company for another course at Seattle University. Submitting a report on a company covered by one or more of the restrictions above for any member of the group will be considered a violation of Seattle University's code of academic honesty.
- (5) All members of a group must be in attendance and actively involved in the discussion when their group is presenting. Absentee members will receive an "I" (incomplete) grade in the course. The "I" grade will be replaced by a definitive grade after the student presents the project individually to the instructor.
- (6) It is a good idea for each group to develop a contract early in the quarter specifying what is expected from its members and how peer evaluations will reflect performance.
- (7) Teams can expel members, and members may resign from their teams and form new teams anytime before the end of the fourth-class. The larger new sub-team may keep the company previously chosen. The smaller new sub-team must choose a new company to analyze. If both sub-teams are of the same size, and there is no agreement, I will decide by means of a random draw.

6. 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." (link: [Academic Honesty Policy](#)) If you are not sure about whether an action is acceptable per the Academic Honesty Code, you should check with me *before* engaging in it.

As required by University regulations I must report to 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. Per 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.)

If group assignments (e.g.: term projects, Excel models, homework solutions) are found to be in violation of the academic honesty code, I may recommend that the entire group receive a grade of zero in the assignment without the chance to resubmit. You should make every effort to verify that work submitted with your name on it does not involve dishonest behavior. If you suspect dishonest behavior by one or more of your team's members, please let me know before submitting the assignment, or resign from the group and submit your work either independently or with another group.

7. Class Conduct

I expect the highest level of professional conduct at all times. Reading of non-class materials must stop once class begins. Cell phones and any other electronic devices must be turned off and earphones removed during class. Laptops can only be used for activities related to the class. Using a computer for activities unrelated to the class (except during the break) can be profoundly disturbing to your fellow students. The fact that I do not always complain in class about non-professional behavior does not mean that I condone it. It simply means I am often embarrassed to call attention to such behavior in front of the class. Non-professional behavior will count as negative participation.

8. On Assignments

Due dates for assignments are given in the schedule. I do not grade assignments that are turned in late. I also will not grade assignments that show a high level of carelessness in presentation quality. Assignments that I do not grade for this reason cannot be resubmitted. Written assignments must be turned in on the due date in class in hard-copy format.

Please observe the following additional guidelines in your papers:

- (1) Type your paper and submit everything as a single file.
- (2) Number your pages.
- (3) Give credit when quoting or using the work of others. Not doing so is a violation of Seattle University's Academic Honesty Policies.

9. On Team Work

Team work is designed so that you all can take on more complex projects (than you would be able to individually) and to help you improve your ability to work effectively in teams.

Often students choose one of two simple strategies to deal with team assignments: (i) divide-and-conquer: split the task evenly, concentrate on your share, and ignore the rest; (ii) extreme specialization: choose to do only the part of the assignment that you are most proficient in. Both strategies tend to defeat the purpose of team work and hurt your learning experience. Please let me know if I can help with ideas for organizing your team and distributing the workload.

Another common approach is to be a "free-rider": pretend the problem doesn't exist and your teammates will do the project for you. To make this approach less attractive, each student's contribution to a project is evaluated by all the other members of the team and by myself.

Important note regarding academic dishonesty and team projects:

- Saying that you did not know that a certain member of your group did not do their work properly and/or was cheating (e.g., plagiarizing) does not protect you from getting a low grade in a group assignment. Be sure you know where any work came from, and how it was prepared, before you put your name on it. If you are suspicious ask about how the work was done, and try to determine whether your teammate would have been capable of doing it.

- If academic dishonesty is involved in group work, the individual student who committed the dishonest act will receive a grade of zero in the entire project. However, the grade in that individual's component of the project will still be zero for *all* members of the group.

10. Class Schedule and Office Hours

I have prepared a week-by-week tentative distribution of topics throughout the quarter. Please check the schedule for assignment deadlines, exam dates, and topics that we will cover in class each time we meet. I may adjust the schedule from time to time as the course progresses due to variations in the time needed to explain each topic. I will announce any scheduling changes by email and in class with sufficient time for you to prepare.

My office hours are posted in the header of the syllabus. Office hours are a great opportunity for you and me to discuss the course, financial accounting concepts, career choices, or any other topic that you think I may be able to help you with. It is best to come to office hours regularly throughout the course, rather than just before an important deadline, because at that time many of your classmates may want to see me as well. Office hour meetings are on a first-come first-served basis, and there is no need to make an appointment to meet with me during office hours.

11. 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, I encourage you to arrange special support services and/or accommodations through Disabilities Services staff in the Seattle University Learning Center (Loyola 200, tel. 206-296-5740). Disability-based adjustments to course expectations can only be arranged through this process. You should also let me know at the beginning of the course so that I can make appropriate arrangements for you.

12. Learning Center

The University's Learning Center provides academic support and study skill enhancement for all students. Experienced staff explore specific academic needs with students in individual consultations. The Learning Center also provides tutors, learning strategy workshops, learning styles assessment and assistance with improving time management, reading comprehension,

test preparation and test taking. All services are free. Additional resources are located on the Learning Center's website at www.seattleu.edu/sas/LearningAssistance. To make an appointment, stop by Loyola 100 or call (206) 296-5740.

13. Online Communications

I expect that you will check Seattle University's email frequently. Please use Seattle University email instead of Canvas email, as it is easier for me to follow the thread of the conversation. Also, avoid communicating with me by means of the multiple text messaging windows available within Canvas, as it becomes very difficult to monitor multiple sources of messages. I cannot guarantee replying to messages sent by any means other than SU email.

Online communications are not meant to substitute for class attendance. Some materials may be distributed only in class, and many course-related announcements will be made only in class. The fact that you did not receive materials by electronic means is not an acceptable reason for failing to meet assignment deadlines if those materials were distributed in class.

I plan to check email daily on weekdays and will reply to your messages within 24 hours except during weekends and holidays. *Do* write to me if you must miss class. *Please include the course title in the subject line of your messages to me.* Due to the threat of viruses, I usually delete without reading messages without a subject, or with a subject that I find suspicious.

14. Course Evaluations

Towards the end of the quarter you will receive a message from the Albers School with instructions on how you can provide us with your opinion on the conduct of this course, its strong and weak points, and recommendations for the future. Please contribute to our continuous improvement by completing your course evaluation forms online and turning them in on time. We treasure your feedback. With your ideas and suggestions, comments and constructive criticism, we will continue working to make Seattle University and the Albers School of Business and Economics a wonderful place to grow and learn, for you and for future generations of students. Keep in mind that students' evaluations are completely anonymous. I will only have access to the results (never to the source) after posting final grades in the course.

15. Tentative Class Schedule and Distribution of Topics

Date	Topic	Study	Deliverables (*)
1. Jan 9	Introduction. Course objectives, assignments, grading. Groups. Sources of information on companies and securities: finance web sites, WRDS.	LS Ch. 1 LS Ch. 2 LS Ch. 3	<u>Note</u> : Study of these three chapters should be completed by January 23.
- January 16, Martin Luther King Day -			
2. Jan 23	Accounting analysis. Review and analysis of the SoCF. Analysis of accounting quality.	LS Ch. 4 LS Ch. 6	
3. Jan 30	Analysis of performance (returns) using basic and advanced Dupont methods. Analysis of financial risk. Models to estimate credit rating, pr(bankruptcy).	LS Ch. 5	HW#1
4. Feb 6	Financial forecasting. How to design, build, implement, and use a reliable financial forecasting model in Excel.	LS Ch. 7 LS Ch. 8	
5. Feb 13	Valuation models. Drivers of M-to-B and P/E. Residual income (RIM) and discounted cash flow (DCF) models. Performing a "reality check".	LS Ch. 10 LS Ch. 11	HW#2
- February 20, Presidents' Day -			
6. Feb 27	EXAM PREPARATION: An in-class exercise on obtaining data, computing ratios, interpreting ratios, forecasting, and writing brief reports. (laptop needed).	LS Ch. 1-8, 10, 11	<u>Note</u> : This exercise will be on publicly traded company "A".
7. Mar 6	MIDTERM EXAM: An in-class exercise on obtaining data, computing ratios, interpreting ratios, forecasting, and writing brief reports. (laptop needed).	LS Ch. 1-8, 10, 11	HW#3 <u>Note</u> : This exercise will be on publicly traded company "B" (different from "A").
8. Mar 13	Cost of capital. (First 60 minutes.) Group work with instructor to finalize valuation projects, including presentation slides.	LS Ch. 9	
9. Mar 17 (Friday)	PROJECT PRESENTATIONS (in lieu of final exam)		<u>Note</u> : Every member of the group must be in attendance and available for Q&A.

**Attachment I:
Homework Exercises (group)**

HW#1:

- (1) Run eVal for the company you are considering for your term project and one peer company.
- (2) Create a well-formatted table in Word summarizing and contrasting selected input and output variables for these two companies.
- (3) Compare your forecast of net income for 2017 with the market's expectations per Yahoo Finance for the company you are considering for your term project. Are your forecasts and the market's very different? If so, why?

Deliverables: Word document with answers to items 2 and 3 on Canvas, AND hardcopy in class. Due time: beginning of class.

HW#2:

- (1) Write a short (2-page max.) analysis of the advanced Dupont and risk ratios for your target company, with both cross-sectional and time-series perspectives. Include at least one well-formatted graph and one table.
- (2) How are the advanced and basic Dupont methods different? Which variation of the Dupont method do you prefer and why?

Deliverables: Word document with answers to items 1 and 2 on Canvas, AND hardcopy in class. Due time: beginning of class.

HW#3:

- (1) Explain the concept of accounting quality, and describe two ways of assessing accounting quality.
- (2) Investigate and discuss accounting quality for your company. List any issues of concern, or explain why there is no reason to worry.
- (3) Estimate the fair value of your company using eVal under different scenarios (e.g.: best-case, expected, worst-case). Each scenario is defined by a combination of values of your key assumptions. Present your results in a well-formatted table, and discuss your findings. (Topics for discussion may include: assumptions you need to work on; whether your recommendation seems to "make sense"; if not, what do you think is wrong?)

Deliverables: Word document with answers to items 1-3 on Canvas, AND hardcopy in class. Due time: beginning of class.

Attachment II: 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; (5) forecasts of financial statements; (6) assessment of the fair value of the company's equity; (7) 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 6.6) and in Beneish's article on the detection of manipulation. (You should apply at least one of these techniques, preferably both.)

Sections 5 and 6: *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 7: *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;
- (4) Word file of paper;
- (5) Powerpoint file of presentation.

**Attachment III:
Security Analysis and Valuation Report: Grading Rubrics (*/**)**

		1(☹)	2	3	4	5(☺)	PTS
I. ORAL PRESENTATION							10
Individual	(6)						
Group	(4)						
II. WRITTEN & VISUAL COMMUNICATION							25
Strength of argument	(10)						
Clarity, grace, style, correctness	(5)						
References	(2)						
Powerpoint slides	(5)						
Charts and pictures	(3)						
III. FINANCIAL STATEMENT ANALYSIS							40
Analysis of profitability	(8)						
Analysis of efficiency	(8)						
Analysis of financial risk	(8)						
Analysis of accounting quality	(8)						
Analysis of business/general	(8)						
IV. FORECASTS & VALUATION							25
Model	(10)						
Assumptions	(10)						
Comps with market	(2½)						
Sensitivity analysis	(2½)						

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

(**) If any item above is not applicable for your project, its points will be redistributed pro-rata among the remaining items in that category.

Attachment IV: 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 than 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)