

**UNIVERSITY OF MICHIGAN BUSINESS SCHOOL**

**ACC 712**

**Financial Statement Analysis**

**Winter 2007**

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**INTRODUCTION**

This course (i) provides you with a framework for business analysis and valuation using financial statement data; and (ii) gives you practical advice when using the framework to value a firm. The course assumes that you have a good working knowledge of accounting, finance, economics and business strategy. The focus is on integrating key concepts from each of these areas and applying them to real world problems. The course places a heavy emphasis on illustrating the latest techniques and information sources used by Wall Street professionals.

The course is case oriented. 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*, McGraw-Hill Companies, 2<sup>nd</sup> edition.  
ISBN 0073100269.

Lehavy, ACC712 *student Course Material*

*eVal* is a financial spreadsheet application. We will use it extensively, particularly in the second half of the course. The *Course Material* contains cases, teaching notes and other readings that we will be covering during the course. Finally, much of the material for this course will be made available on my ACC712 *CourseTools* page (<https://ctools.umich.edu/>).

## 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/attendance	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 five typed pages, with no more than five 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 on Tuesday and Thursday from 2:10-3:10 and by appointment.

## **COURSE OUTLINE**

### **PART I: INTRODUCTION**

#### **Session 1: Tuesday, January 9**

##### **Course Introduction and Overview of Business Analysis and Valuation**

Reading: *Introduction*, Chapter 1

Case: Chronar Corporation

### **PART II: BUSINESS STRATEGY ANALYSIS AND ACCOUNTING ANALYSIS**

#### **Session 2: Thursday, January 11**

##### **Business Strategy Analysis**

Reading: *Information Collection*, Chapter 2 (skim only)

*Understanding the Business*, Chapter 3

Case: Boston Chicken, Inc. case materials and part A questions

#### **Session 3: Tuesday, January 16**

##### **Accounting Analysis: Introduction**

Reading: *Accounting Analysis*, Chapter 4

Case: Boston Chicken, Inc. case materials and part B questions

#### **Session 4: Thursday, January 18**

##### **Accounting Analysis: Expense Recognition**

Case: Prepaid Legal Services

#### **Session 5: Tuesday, January 23**

##### **Accounting Analysis (Revenue Recognition), and Introduction to Financial Analysis**

Case: Overstock.com

Reading: *Ratio Analysis*, Chapter 5, all but section 10.

### **PART III: FINANCIAL ANALYSIS AND FORECASTING**

#### **Session 6: Thursday, January 25**

##### **Financial Analysis**

Reading: *Cash Flow Analysis*, Chapter 6

Case: Royal Caribbean Part A

#### **Session 7: Tuesday, January 30**

##### **Forecasting (1)**

Readings: *Structured Forecasting*, Chapter 7

*Forecasting Details*, Chapter 8

Case: Royal Caribbean Part B

**Session 8: Thursday, February 1**

**Interpreting Earnings Reports**

Reading: “Pro Forma Proves a Hard Habit to Break on Earnings Reports”

“Coming to Terms”

Case: ‘GAAP’ versus ‘The Street’

**Session 9: Tuesday, February 6**

**Forecasting (2)**

Reading: *Information Collection*, Chapter 2

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

**Session 10: Thursday, February 8**

**Credit Analysis and Default Prediction**

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

Case: A Tale of Two Movie Theaters

**Session 11: Tuesday, February 13**

**Overflow/Review**

Background Reading (not for class): Sample First Midterm Examination

**Session 12: Thursday, February 15**

**First Midterm Examination (in class)**

**SPRING BREAK**

**PART IV: VALUATION**

**Session 13: Tuesday, March 6**

**Valuation Introduction**

Reading: *The Cost of Capital*, Chapter 9

*Valuation*, Chapter 10

**Session 14: Thursday, March 8**

**Valuation Practice**

Case: Four Models, One Valuation, \* In class only – **cannot** be handed in

**Session 15: Tuesday, March 13**

**Valuation – Growth and Profitability**

Case: Intel’s Earnings Torpedo

**Session 16: Thursday, March 15**  
**Market-to-Book and Price-Earnings Ratios**

Reading: *Valuation Ratios*, Chapter 11

Case: The Restaurant Industry in 2003 \* In class only – **cannot** be handed in.

**PART V: SOME COMPLICATIONS**

**Session 17: Tuesday, March 20**

**The Option Value in Equity**

Reading: *Some Complications*, Chapter 12

Case: Amazon.Com

**Session 18: Thursday, March 22**

**Mergers and Acquisitions**

Case: The AOL Time Warner Merger

**Session 19: Tuesday, March 27**

**Overflow/Review**

Background Reading (not for class): Sample Second Midterm Examination

**Session 20: Thursday, March 29**

Second Midterm Examination (in class)

**Session 21: Tuesday, April 3**

Project workshop

**Session 22: Thursday, April 5**

Project Presentations

**Session 23: Tuesday, April 10**

Project Presentations

**Session 24: Thursday, April 12**

Project Presentations and Wrap Up

## 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 or, if you want to get a head start, check out the candidate companies from large-sample screens posted on [www.valuedog.com](http://www.valuedog.com). You need to clear your final selection with me before proceeding.

### 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 15-20 minute project presentation during one of our last 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. Also please attach the firm's most recent 10K filing.