Financial Statement Analysis: C10.0003.01
Fall 2005 – Tuesdays and Thursdays 9:30 A.M. – 10:45 A.M.

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OFFICE HOURS:
Tuesday & Thursday
12:30 P.M. – 1:30 P.M. and by appointment

Course Objectives
This course is designed to prepare you to interpret and analyze financial statements effectively. This course explores in greater depth financial reporting topics introduced in the core course in financial accounting and also examines additional topics not covered in that course. The viewpoint is that of the user of financial statements. This course is designed primarily for students who expect to be intensive users of financial statements as part of their professional responsibilities.

The pre-requisites for this course are the core course in financial accounting and the core course in managerial accounting.

Course Materials
- The readings, problems, and cases for the course come from Financial Reporting and Statement Analysis: A Strategic Perspective, 5th edition, by Clyde Stickney, Paul R. Brown, and James Wahlen.

- We will also be using the Dell Computer 2005 10-K filing during the class. For a pdf printable and downloadable file, go to: http://www.dell.com/downloads/global/corporate/sec/10k-fy05.pdf

Please bring both to class as we will be using them throughout the semester.

Three internet addresses may prove useful to you at some point in the course:

3. Pronouncements of the International Accounting Standards Committee: http://www.iasc.org.uk

Two Make-up Classes
- There will be no class on Tuesday, October 4 (Rosh Hashana) and on Thursday, October 13 (Yom Kippur)
• Make-up classes are scheduled for Friday, September 23 and Friday, October 21. The rooms for these two classes are Tisch 201.

Assignments

• Readings, cases and/or problems are assigned for each class. You should come to class prepared to discuss your analysis of the cases and problems. Regular class participation is important to the learning process for you and your classmates.

• Ten percent of your grade will be based on “class preparation.” You can receive these points either from actively discussing the cases and problems in class or handing in the assignment at the end of the class. No late assignments will be accepted nor will I accept e-mailed or faxed assignments. If you choose to hand in the assignment, please make two copies – one for you and one for me.

• All assignments should be prepared using word processing software with type size no smaller than 12 point. You can include tables or spreadsheets as well, as long as they are carefully labeled and defined. During class discussions, please feel free to make changes to your solutions, but do so in a way that clearly indicates that they are the result of class discussion (e.g., using a different color of ink).

• You may work in groups to discuss homework assignments. However, each person should prepare his/her own individual homework solutions to be submitted. Ideally, you should work through each day’s assignment on your own before discussing it with anyone. You can then make changes to your solution based on your learning in any discussion. Interpretations of the analysis should be in your own words.

• Additional assignments either will be discussed in class or are extra problems for your benefit. I will tell you the assignments that will be discussed in class prior to that class.

Financial Statement Analysis Package
A financial statement analysis package (FSAP) is available to ease the calculation of financial ratios and perform other analyses. Access FSAP and the user manual at http://www.swlearning.com

Examinations
There will be three examinations: October 25, November 29 and the other on the final exam date as fixed by Stern, which is Thursday December 22 – 8 AM – 9:50 AM.

Grading
Grading will be based on the following weights:

Class Preparation 10%
Exam 1 25%
Exam 2 30%
Exam 3 (Final Exam) 35%

Exams 1 and 2 are not cumulative. The final exam is cumulative. If you miss Exam 1 or 2, I will add its percentage weight to the final exam. There are NO make-up exams.

**Blackboard**

I will be using Blackboard to post notes, the syllabus, and to communicate with you throughout the term. If you have any questions as to how to use Blackboard, please see me after class.
Syllabus

September 6  Introduction to Course and Financial Statement Analysis

Learning Objectives:
1. Overview of financial reporting and financial statement analysis
2. Understand most effective means of mastering course

September 8 & 13 & 15  Financial Reporting Highlights

Read: Chapter 1
   Hand-out on Cash Flows (on Blackboard)

Learning Objectives:
1. Review the purpose, underlying concepts, and accounting principles related to the balance sheet, the income statement, and the statement of cash flows
2. Use common size statements to make preliminary interpretations of the profitability and risk of a firm
3. Review key principles that drive the preparation of financial reports
4. Understand the environment in which financial reporting principles are determined, as well as the limitations presented when analyzing a firm using financial reports

*We are going to concentrate on NIKE (Case 1.1). Before coming to class, answer the following questions:*
1. What industry is NIKE in?
2. How competitive is the industry?
3. Describe NIKE’s value chain. What does it imply about (a) the types of assets and liabilities ity would have on its balance sheet and (b) its sources of income?
4. What is the “Futures” ordering program? How does this effect NIKE’s business and consequently financial statements?

Preparation Hand-In: Case 1.1 (NIKE): Note, the questions are on pages 62, 64, 69 and 70
9/8: Hand-in questions relating to Balance Sheet and Income Statement
9/13: Hand-in remaining questions

September 20 & 22 & 23  Statement of Cash Flows

Note: September 23 is on a Friday (Tisch 201).

Read: Chapter 3
Learning Objectives:
1. Understand the relation between net income and cash flow from operations for firms in various industries
2. Understand the relation between cash flows from operating, investing, and financing activities for firms in various stages of their life cycles
3. Prepare a statement of cash flows from balance sheet and income statement data.

9/20: We will go over problem 3.10 in class. Not a hand-in.
9/22: Prepare: Problems 3.1, 3.3, 3.4, and 3.6 (Ignore working capital from operations).

- Examine Dell’s SCF. Note the additional information on page 58. Before coming to class, answer the following questions:
  1. Why is CFO greater than Net Income?
  2. What stage of its life is Dell in?
  3. What does their SCF tell you about the company?
  4. How do they conserve cash?
  5. What does Dell do with its “excess” cash?

9/23: Preparation Hand-In: Case 3.1 (W.T. Grant)

September 27 & 29 and October 6 Profitability Analysis

Note: There is no class on October 4 (Tuesday)

Read: Chapter 4
Learning Objectives:
1. Analyze and interpret changes in the operating profitability of a firm using the rate of return on assets and its components, profit margin and total assets turnover
2. Analyze and interpret changes in the rate of return on common shareholders’ equity including the conditions when a firm uses financial leverage successfully

Note: in doing these problems, you may find the FSAP package to be useful.

9/27 and 9/29 We will go over problems 4.1-4.4 in class. Not a hand-in. Please have the numbers done for the class, as I will not go over the calculations in class.

- Before class, calculate the ROA and its components for Dell for 2005 and 2004 (see exhibit 4.17 on page 217 of your textbook). What do these ratios tell you about Dell for the last few years? Note that the required information is available, but you will have to go through the full Dell
report to find the relevant data. You may also need the 2004 Dell report as well.

10/6: We will go over problem 4.9 in class. Not a hand-in. I suggest that you might want to do problem 4.10 as well, although we will not go over this problem in class.

- **Before class, calculate the ROCE and its components for Dell for 2005 and 2004 (see exhibit 4.17 on page 217 of your textbook).**
  1. What do these ratios tell you about Dell for the last few years?
  2. Relate ROA to ROCE

October 11 & 18            Risk Analysis

**Note:** There is no class on October 13 (Thursday)

Read: Chapter 5 (pages 262-281)
Learning Objectives:
1. Understand the importance of working capital management and apply analytical tools for assessing short-term liquidity risk
2. Understand the benefits and risks of financial leverage and apply analytical tools for assessing long-term solvency risk

10/11: We will go over problem 5.1 in class. Not a hand-in. Do the calculations prior to class. I suggest that you might want to do problem 5.2 as well, although we will not go over this problem in class.

- **Before class, calculate the current ratio, quick ratio, OCF/CL ratios and working capital activity ratios for Dell for 2004 and 2005. Analyze its short-term liquidity risk. Note, for some of the 2004 ratios you will have to have Dell’s 2004 annual report.**
- **Why is purchases = COGS + EI – BI (page 269 in text book)?**
- **Calculate the debt ratios, interest coverage ratio, and the OCF/TL for Dell for 2004 and 2005. Analyze its long-term liquidity risk.**
- **Read the footnote on Long-term Debt and Interest Rate Risk Management (pp. 46-47). How has Dell structured its debt and interest rate payments to minimize its risk?**

10/18: Preparation Hand-Ins: Case 4.1 (Wal-Mart) and Case 4.2 (Gap & Limited)

October 20            Bankruptcy Analysis

Read: Chapter 5 (pages 281-296)
Learning Objective:
1. Understand the how financial statements can be used to predict bankruptcy probabilities

We will go over problem 5.6 (parts a, c and d) in class. Do the calculations before class. Not a hand-in.

- Before class, calculate Altman’s Z-Score for Dell for 2005. What factors contribute most to Dell being a financially healthy company?

October 21 & 27  Data Issues in Analyzing Financial Statements

Read: Chapter 6
Learning Objectives:
1. Develop an understanding of the concept of “earnings quality” with emphasis on sustainability, measurement and manageability of reported earnings
2. Master the ability for deciding when and how to adjust reported income in order to use it in evaluating performance and in predicting future earnings of a firm

10/27: Preparation Hand-In: Problem 6.4

- Before class, examine Dell’s Statement of Stockholders’ Equity (page 39). What items are included in Dell’s comprehensive income?
- Before class, examine Dell’s income statement. Are there any items that should be excluded from “permanent” income? Look in the footnotes for further details.
- Does Dell include depreciation expense in SG&A?
- Does Dell include R&D expense in SG&A?

October 25  Exam 1 (will cover everything through 10/20)

November 1 & 3 & 8 & 10  Income Recognition, LIFO Footnote Adjustments, Fixed Assets, Intangibles

Read: Chapter 7 (Skip Comprehensive Illustration of Income Recognition Methods for Installment Sales, pp. 445-448; Depreciation Method, pp. 462-463).

Learning Objectives:
1. Observe the effects on the financial statements of recognizing income prior to the time of sale, at the time of sale, and subsequent to the time of sale
2. Observe the time series pattern of income when firms recognize income prior to the time of sale, at the time of sale, and subsequent to the time of sale
- Review the accounting for inventories and depreciable assets
3. Examine the impact on assets and net income of capitalizing and amortizing intangibles development
4. Identify the financial statement effects of alternative ways of organizing research and development activities and restate the income statement to a format that enhances analysis of the profitability of a technology-based firm.


- Before class, examine Dell’s financial statements, footnote 1 (Revenue Recognition), footnote 7 (Deferred Revenue and Warranty Liability) and footnote 10 (Supplemental Consolidated Financial Information).
  1. Describe Dell’s revenue recognition rules? Are they GAAP?
  2. How do their rules impact their financial statements?
  3. How does footnote 7 impact the statement of cash flows?

- Before class, examine the financial statements and footnotes for Wal*Mart and for Halliburton (they will be distributed prior to class)
  1. How do these firms recognize revenues?
  2. Should Halliburton use the percentage of completion method?
  3. How do these firms’ revenue recognition rules impact their financial statements?

11/8: Prepare 7.6 (Parts A&B). Not a hand-in.

- Before class, examine Dell’s disclosures on inventories.
  1. What cost flow method does Dell use for its inventories?
  2. How does this cost flow method impact its inventory turnover ratio?

11/10: Prepare 7.7 (Parts A&B) Not a hand-in.

- Before class, examine Dell’s disclosures on its long-term assets.
  Can you accurately compute its total depreciable life for its depreciable long-term assets? If not, why not?

November 15 Liability Recognition and Valuation

Read: Chapter 8, Pages 519-534; Go into www.FASB.org and read SFAS 140
Learning Objectives:
1. Understand and apply the concept of an accounting liability to various transactions intended to keep debt off of the balance sheet
2. Observe the importance of identifying the entity bearing the risks and enjoying the economic return when deciding liability recognition issues
3. Understand securitization of receivables
Prepare: Problem 8.2

- Read page 25 (Off-Balance Sheet Arrangements) and footnote 6 (Financial Services) of Dell’s 10-K report. How did Dell “get around” the consolidation of DFS to remove its receivables from its balance sheet?

November 17 & 22 Leases

Read: Chapter 8, Pages 534-546
Learning Objectives:
1. Understand the distinction between the operating lease method and the capital lease method, including the criteria for using each method and their financial statement effects
2. Convert firms using the operating lease method to the capital lease method

11/17: Preparation Hand-In: Problem 8.4
- Prior to class, read footnote 6 (Financial Services), footnote 8 (Lease Commitments) and Item 2 (Properties) on pages 15-16 in Dell’s 10-K report.
  1. As a lessee, how does Dell account for its leases?
  2. As a lessor, how does Dell account for its leases?

11/22: Preparation Hand-In: Problem 8.6

November 29 Exam 2 (covers Chapter 6 through Leases)

December 1& 6 Accounting for Income Taxes

Read: Chapter 2, Pages 84-93; Chapter 8, Pages 580-594
Learning Objectives:
1. Understand the need for recognizing deferred income tax expense when book income differs from taxable income because of temporary differences
2. Understand the conditions that give rise to deferred tax assets and deferred tax liabilities
3. Use the disclosures of individual tax assets and deferred tax liabilities to study amounts recognized for financial and tax reporting
4. Use disclosures of the effective tax rate to understand why a firm’s average tax rate differs from the statutory tax rate
5. Analyze the impact of income taxes on assessments of profitability
12/6: Preparation Hand-In: Answer the following questions about Dell Computer (2005 only)

1. What is Dell’s effective tax rate? Show the calculations supporting this number.
2. What accounts for the difference between the 35% U.S. statutory tax rate and Dell’s effective tax rate?
3. What is Dell’s tax expense? What is its taxes payable? Show the journal entry for tax expense.
4. Why does “deferred revenues” increase Dell’s deferred tax assets (p. 48)? Look at footnote 7 and use that disclosure to try to explain the increase.
5. Why does “fixed assets” increase Dell’s deferred tax liabilities (p. 48)?
6. Where on the balance sheet do the deferred liabilities appear?

December 8 & 13  Introduction to Pension and Heathcare Benefits

Read: Chapter 8, Pages 564-580
Learning Objectives:
1. Distinguish between the amounts that firms report on their financial statements with respect to a pension or healthcare benefit plan and to the amounts that appear on the financial statements of the pension or healthcare benefits fund and understand why the two differ
2. Use pension and healthcare disclosures to measure the economic status and financial performance of a pension or a healthcare benefits plan
3. Observe the role of actuarial assumptions in accounting for pensions and healthcare benefits
4. Understanding reserves in the financial statements

Prepare: Problem 8.12

• Before class, examine Note 5 (Benefit Plans – 401(k) Plan) on page 50 of the 10-K report.
  1. What type of pension plans does Dell have?
  2. How do these plans appear on Dell’s financial statements?

If there is a demand, I will schedule a Review for Final Exam later this week.

December 22  Final Exam (8 A.M. – 9:50 A.M.)