FIN324 Financial Statement Analysis

Subject Program

Autumn Session 2004, Wollongong Campus

(a) Subject Description

FIN324 develops knowledge and skills in the principles and techniques of analysis of accounting information contained in financial statements. The emphasis is on practical application of these skills. The subject introduces the language and concepts of financial information analysis, and examines the role of financial information analysis within a framework of overall business analysis. The course applies the techniques of financial information analysis to specific areas of business analysis that are commonly met in practice. The subject explores the varied sources of financial information used in developing financial analyses of firms. The financial information considered in this course is primarily publicly available accounting information, although other sources of information relied on in corporate financial analysis are also taken into account.

(b) General Learning Objectives

1. Upon completion of this subject students should have sufficient theoretical understanding and analytical skills to:
2. Describe and discuss the main steps in business analysis and valuation using financial statements,
3. Enumerate and discuss the major applications of business financial analysis
4. Evaluate firms on the basis of available financial information,
5. Assess the relevance, reliability and general quality of financial information available in given contexts,
6. Model and allow for the incentives underlying the supply and demand for financial information,
7. Comprehend the reaction of equity and debt markets to the release of particular financial information,
8. Model the investment decisions of equity market participants and corporate lenders, and their consequent financial information requirements,
9. Have knowledge of the statistical and other properties of financial statement numbers,
10. Explain lucidly and succinctly the basic concepts and tools of corporate financial information analysis.

(c) Prescribed text
(d) Subject Requirements and Assessment

For the purposes of determining final grades for FIN324, student performance will be evaluated on a composite mark, determined as follows:

<table>
<thead>
<tr>
<th>Component</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Case study</td>
<td>20%</td>
</tr>
<tr>
<td>Tutorial work</td>
<td>10%</td>
</tr>
<tr>
<td>Final Exam</td>
<td>70%</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
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</table>

To be awarded a Pass or higher grade in this subject, students must attain at least 40% of the total marks assigned to the final examination. Final composite marks may be scaled.

(e) Exam

A final three-hour exam will be held in this subject. The exam will include subject matter covered in lectures and/or tutorials. You should study from your class notes, supplementing this material with explanations and further example problems from the textbook as necessary. The problems which you will be asked to solve and discuss in exams will not be the same as those discussed in classes, but will require application of the same concepts and techniques. The objective is to test your understanding of class material rather than mere memory.

(f) Access to Lecturer

Course Coordinator: Associate Professor Michael McCrae
Room 40.323, Ph.0242 214015, Email: mccrae@uow.edu.au

Tutors: Zaffar Subedar
Administrative arrangements for FIN324 will be the responsibility of Associate Professor Michael McCrae. Consultation times will be posted on the door of Room 40.323.

<table>
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<tr>
<th>Lectures</th>
<th>Lecture Tuesday 12:30-13:30 Lecture Theatre 20.3</th>
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<tr>
<td>Lecture</td>
<td>Wednesday 16:30-17:30 Lecture Theatre 20.2</td>
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(g) Tutorial Attendance

1. All queries regarding tutorial enrollment, changes etc are through Ms. T. Mak, room 30.333
2. Attendance at a minimum of **ten** tutorials is a compulsory requirement for a pass or higher grade in this subject.
3. Satisfactory submission of required tutorial work makes up your mark for tutorial work (see above).
4. Solutions to tutorial problems are to be submitted to tutors as required. Your tutor will provide further details on frequency and method of submission.

Submissions – **All** submitted material must be accompanied by the School Assignment Sheet cover available online at:

Submission
1. A submission box will be located outside the coordinator’s office door on this date. Work will be returned during tutorials.
2. A medical certificate must accompany any request for consideration.
3. Any case studies submitted after the due date will incur a penalty (one mark per day), which may reduce the mark to zero, unless special exemption has been granted prior to the due date.
4. Problems with computers, software, lost disks etc will not be accepted as excuses for late or non-submission. In particular, no extensions will be granted for loss of work due to failure to back-up work on a separate disk.
5. The group must ensure its capacity to provide a duplicate submission, should this be requested.

Completion Requirements
1. The Case study is to be undertaken by class members working in groups of three/four. Class members may not change groups after week four of the semester.
2. It is intended that groups should choose the area of business analysis application for each case study from the areas covered by lectures up until the submission date of each study.
3. The Case study does NOT include Prospective analysis.
4. Groups are not to use the cases that form the basis of lectures given before the submission date.
5. The final group mark for each case study becomes the mark of each individual group member.
6. It is likely that several groups will choose each case study in Palepu. Evidence of plagiarism between group reports is viewed seriously and will result in loss of marks for all parties.

Assessment of case studies will be based on a report submitted by each group. Each group is to consider itself as a team of analysts submitting a business analysis report to a client, which they will then use as a basis for action or decision-making.

An integral part of the report involves each group defining the area of business analysis application, which is to be the focus of the report. In other words, the group is to carefully and fully define the business analysis application area they are targeting in each case study and the particular problem areas they will address in their report to the client. Reports will address at least the following areas in their structure

1. The area of analysis and the specific issues under investigation - assume the client who employs your group as analysts has a specific purpose or action in mind that motivates them to seek a business analysis report.
2. The scope of the investigation and any limitations
3. The aim of the investigation and the purposes to be achieved
4. The method of analysis and details of analysis
5. The results of analysis
6. Interpretation of results
7. Recommendations to client

Suggestions
1. Include a two page executive summary with the report that summarizes the purpose and scope of the investigation, limitations, method, results, interpretation and recommendations to the client.
4. Include within the report evidence of wider reading about the issues and problems, which may arise in the chosen area of business analysis.

**Mandatory case study presentation standards are as follows:**
1. The case study is to be typed using a computer word processing package.
2. Pages should be numbered.
3. At the front of the essay there must be a title page showing your name, your tutorial class, the date the essay is due and the topic as given.
4. An executive summary of not more than two pages to preface the case study.
5. There must be a margin of about 40 mm to allow for written comments.
6. All essays should include a list of references in academic form. All sourced material, including direct quotations, should be appropriately acknowledged.

Case studies will be penalized for failure to meet any of these requirements.  
*Students not submitting both case studies by the due dates will, in the absence of acceptably documented reasons, fail the subject.*

Cover sheets will be issued for both case studies. Reports will only be accepted with this cover sheet attached and signed by all group members. Acknowledgement of submission will be by return of the 'receipt' portion of the cover sheet during lectures/tutorials.

(i) **Supplementary Exam and Special Consideration Policy**

Refer to the University of Wollongong Calendar on supplementary exams and special consideration. Also refer to the statement of Departmental policy, copies of which are available in the Faculty of Commerce Resource Room in Building 40 and online.

The Department wishes to emphasize that the response to requests for supplementary or special consideration will normally be to refuse a supplementary exam and assess the students on available evidence. If supplementary exams are granted they may be written or oral and they will be held under exam conditions and held in the week commencing 3 weeks after the last date of the formal examination period. Only one supplementary exam may be held per subject.

If a student requests a supplementary exam or special consideration, then it is the student's responsibility to be available during the above period, in case a supplementary is granted.

The highest grade that can be assigned to the overall results of a student having done a supplementary exam will normally be a pass.

The attention of each student is drawn to the Code of Practice section in the University Calendar 2004 and particularly the section on assessment. The Code of Practice - Teaching and Assessment is available on the UOW website at http://www.uow.edu.au/about/teaching/teaching_code.html

If special consideration is sought in relation to any of the elements of assessment (essay, computer assignments, tutorial attendance, exams), a signed request for special consideration must be submitted to the lecturer before the element is taken, or if not undertaken, then as soon after as possible. A medical certificate must accompany requests.

(j) **Plagiarism**
first two weeks of the course. The cover sheets provided for handing-in of assignments also require
acknowledgement of this issue. The document 'Acknowledgement Practice' is available on-line to
and in the Student Guide. A shortened copy is appended to this subject outline.

(k) Workload
The amount of time to be spent on the subject each week. According to Course Rule 003
(Interpretation Point 2(t)) each credit point for a single session subject has a value of about 2 hours per
week-including class attendance (Calendar 2004). This unit carries 6 credit points.

(l) Disability
“If a student with a disability requires reasonable accommodation in this subject, they are strongly
advised to discuss the issues early in the session with one of the following people: the Disability
Liaison Officer, Faculty Disability Advisor and/or the Subject Coordinator”. For the Faculty of
Commerce, please see the Sub-Dean.
AUTUMN SESSION  2004
16 February - 20 February Orientation Week
23 February - 8 April Lectures Commence (7 weeks)
9 April - 16 April Mid-Session Recess (1 week)
19 April - 28 May Lectures Recomence (6 weeks)
31 May - 4 June Study Recess (1 week)
5 June - 18 June Examinations (2 weeks)
21 June - 16 July Mid-Year Recess (4 weeks)

<table>
<thead>
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<th>Lecture</th>
<th>Topic</th>
<th>Reading</th>
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<tr>
<td>Week 1</td>
<td>#1/2 Framework for Analysis</td>
<td>Ch 1</td>
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<tr>
<td></td>
<td><strong>Business Analysis Tools</strong></td>
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<tr>
<td>Week 2</td>
<td>#3/4 Business Strategy Analysis</td>
<td>Ch 2</td>
</tr>
<tr>
<td>Week 3</td>
<td>#5/6 Accounting Analysis</td>
<td>Ch 3</td>
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<tr>
<td>Week 4</td>
<td>#7/8 Financial Analysis (1)</td>
<td>Ch 4-6</td>
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<tr>
<td>Week 5</td>
<td>#9/10 Financial Analysis (2)</td>
<td>Ch 7-9</td>
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<tr>
<td>Week 6</td>
<td>#11/12 Prospective Analysis: Forecasting</td>
<td>Ch 10</td>
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<tr>
<td>Week 7</td>
<td>#13/14 Prospective Analysis Accounting Based Valuation</td>
<td>Ch 11-12</td>
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<td><strong>RECESS FROM 9th TO 16th APRIL</strong></td>
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<tr>
<td>Week 8</td>
<td>#15/16 Prospective Analysis Discounted Cash Flows and Valuation Implementation</td>
<td>Ch 11-12</td>
</tr>
<tr>
<td></td>
<td><strong>Business Analysis Applications</strong></td>
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Answers to tutorial questions are to be submitted at the tutorial number indicated below. Tutorials lag the lectures by one week.

**Tutorial 1. Framework for Analysis**
1. Identify and describe each step in Palepu's Framework for business analysis.
2. Explain the objectives/purposes of each of the four steps in Palepu's Framework.
3. Explain why each of the four steps for business analysis described in Palepu is a critical part of a financial analyst's job and how they relate to each other.
4. Joe Smith argues "learning how to do business analysis and valuation using financial statements is not very useful, unless you are interested in becoming a financial analyst." Comment on this statement.

**Tutorial 2. Business Strategy Analysis**
1. Case: The Home Depot. Evaluate Home Depot's business strategy. Do you think it is a viable strategy in the long run?
2. An accounting major student argues, "Strategy analysis seems to be an unnecessary detour in doing financial statement analysis. Why can't we just get straight on to the accounting issues?" Explain why the student might be wrong.
3. What are the critical drivers of industry profitability?

**Tutorial 3. Accounting Analysis**
1. Case: Harnischfeger Corp. Identify the major accounting policy changes that Harnischhefer made during 1984. What do you think are the motives of management for making the changes in each case?
2. A finance student states, "I don't understand why anyone pays any attention to accounting earnings numbers, given that a 'clean' number like cash from operations is readily available." Do you agree? Why or why not?
3. Fred argues 'The standards I like most are the ones that eliminate all management discretion in reporting - that way I get uniform numbers across all companies and don't have to worry about doing accounting analysis." Do you agree? Why or why not.
4. If a management reports truthfully what economic events are likely to prompt the following accounting changes:
   - Increase in the estimated life of depreciable assets
   - Decrease in the Bad Debts Allowances as a percentage of gross receivables
   - Recognition of revenues at the point of delivery, rather than at the point cash is received.
profitability provided the Gap with its "edge" in 1991? What appear to be the sources of that edge? Do you think the profitability is sustainable?

2. In relation to the financial analysis of the Assets, Liabilities, Equities and Revenues, answer the following questions.
   a. Identify the main accounting reporting convention underlying each item.
   b. Identify the critical reporting challenges for each, and discuss why they are critical.
   c. Identify two misconceptions about reporting for each item.

Tutorial 5  Financial Analysis (2)


2. What ratios would you use to evaluate the following management areas of a firm?
   a. Operating
   b. Investment
   c. Financing
   d. Dividend policy

3. What ratios would you use to evaluate the following for a firm?
   a. Financing policy
   b. Profitability
   c. Creditworthiness
   d. Market valuation (stock price)
   e. Take-over potential

Tutorial 6  Forecasting Earnings and Cash flows


Tutorial 7  Forecasting the Value of the Firm - Accounting Based Valuation


2. What are the major steps in the AE and ROE methods of estimating firm valuation? What assumptions are required?

Tutorial 8  Forecasting the Value of the Firm - Discounted Cash Flow Valuation


2. What are the major steps in the DCF method of estimating firm valuation?

Tutorial 9  Equity Security Analysis

   a. With stock price at $55 per share in early 1992, use the DCF and DAE methods to infer what possible combinations of profitability, growth and cost of capital would be necessary to justify the $55 price.
Tutorial 10  Credit Analysis/Distress
   a. Do you think the company's financial strategy is appropriate, given its business?
   b. Should Sarah Kim grant the loan to Adelphi? What would be the appropriate terms
      (interest rate, covenants, security requirements, etc)?
   c. What financing options should Adelphi pursue if the bank does not grant the loan?
2. Identify and explain the content and purpose of each of the five major steps in the Credit Analysis
   process.
3. Define and discuss the purpose and components of the Altman Z-score model.

Tutorial 11  Mergers and Acquisitions
1. Case: Schneider-Square D.
   Assess and discuss the strategic fit between Square D and Schneider. What are the economic pros and
   cons of a combination? What synergies would be gained by each company? What may be potential
   future disadvantages?
2. Identify and discuss 6 possible motivations for a merger or acquisition.
3. Identify and explain the steps in the Earnings Multiples and the DCF methods of estimating a
   target's value to an acquirer.

Tutorial 12  Corporate Financing
1. Case: Murray Ohio Manufacturing
   a. Given its recent financial performance and cash flows, can the company afford to
      maintain its current dividend if operating conditions remain about the same?
   b. Evaluate management new business strategy into the future and its implications for future
      cash flow requirements. Will the new strategy make maintenance of current dividend
      policy more or less likely?
2. Case: CUC
   a. What are CUC's key success factors? What are its main sources of finance?
   b. Is CUC's policy of capitalizing membership acquisition costs appropriate? Does it help
      reflect the company's operating performance?
   c. How might the management use finance policies to enhance its stock price?

Tutorial 13  Revision
2. Call #657.3/32.
Author Sprouse, Robert T.
Imprint Reading [Mass.]
Lib. Has
1 > Main Lending-1st Floor 657.3/32 *Supp
2 > Main Lending-1st Floor 657.3/32 C.2
3 > Main Lending-1st Floor 657.3/32 *Suppl C.2
4 > Main Lending-1st Floor 657.3/32

Author Stickney, Clyde P. (Clyde Pierce), 1944-
Title Financial Reporting And Statement Analysis : A Strategic Perspective / Clyde P. Stickney.
Edition 3rd Ed.

4. Call #657.3/56.
Author Foster, George.
Title Financial Statement Analysis / [By] George Foster.
Imprint Englewood Cliffs.

5. Call #657.33/3.
Author Bernstein, Leopold A.
Title Financial Statement Analysis : Theory, Application, And Interpretation / Leopold A. Bernstein.
Edition 3rd Ed.

6. Call #657.33/4.
Author Bernstein, Leopold A.
Edition Rev. Ed.

7. Call #657.3/156.
Author Stickney, Clyde P. (Clyde Pierce), 1944-
Title Financial Statement Analysis : A Strategic Perspective / Clyde P.


**Plagiarism**

Extract from 2004 on-line Calendar at

"ACKNOWLEDGEMENT PRACTICE

Plagiarism

In a university, ideas are important, and it is also important to give people appropriate credit for having ideas.

There are several reasons why you should give people credit when using their ideas; three of the more important of those reasons are:

"fairness to authors and other students, the responsibility of students to do independent work, and respect for ownership rights."1

If, in writing an essay or report, you copy a passage from a book word-for-word and don’t give a reference to the book, this is:

unfair to the author who wrote the passage in the book;
unfair to other students who do their own work without copying;
failure to do independent work as expected in a university; and
breach of copyright.

Giving and gaining credit for ideas is so important that a violation of established procedures has a special name: plagiarism. Plagiarism means using the ideas of someone else without giving them proper credit. That someone else may be an author, critic, journalist, artist, composer, lecturer, tutor or another student. Intentional plagiarism is a serious form of cheating. Unintentional plagiarism can result if you don’t understand and use the acceptable scholarly methods of acknowledgment. In either case, the University may impose penalties which can be very severe.

Over many years, procedures have been developed for acknowledging ideas in all forms of expression. In published writings, for example, authors are expected to give references to articles and books on which they have relied, and to give written thanks to people who have helped them in preparing their work.

There are several methods for giving credit in written work and the lecturers and tutors in the academic units in which you study should inform you about methods that are acceptable to them. A good way to gain a better understanding of those methods in a particular discipline is to read articles published in academic journals of that discipline.

The following examples will help you understand some of the common methods for acknowledging your sources. If you have any questions about these methods, check with your lecturer or tutor.

Acknowledging Sources of Quotations

[Continues...]

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Correct.

The bibliography should then include:


Example 1 is presented using the author-date system in which the author of the work and the date the work was published are listed in brackets.

Example 2: "The subjugation of thought in Australia through stringent censorship and draconian defamation laws has existed throughout the 200 years of white settlement."2

Correct - see the footnote (reference at bottom).

Example 2 is presented using the footnote system in which the full reference is given as a footnote. You should be aware that, depending on the system your lecturer or tutor prefers, you may use either footnotes at the foot of the page or endnotes at the end of the text.

Example 3: The subjugation of thought in Australia through stringent censorship and draconian defamation laws has existed throughout the 200 years of white settlement.

Wrong and very bad: this is a direct quote from Pollak and therefore should be placed in quotation marks followed by a reference using the author-date system or the footnote or endnote system.

If you use a quote, the words in quotation marks must be copied exactly as they are in the original source.

Example 4: "In Australia, stringent censorship and draconian defamation laws have existed throughout the two hundred years of White settlement" (Pollak, 1990, p.7).

Wrong: the quote is inaccurate in several places.

If you change or add anything, use square brackets [ ] to indicate the place where the alteration is located. If you omit something from the quote, use a line of dots .... to indicate the location of the omission.

Example 5: Pollak claims that censorship and defamation law have been the means for "[t]he subjugation of thought in Australia .... throughout the 200 years of white settlement" (Pollak, 1990, p.7).

Correct.

Acknowledging Sources of Ideas

Even if you are not using the exact words of somebody else, it is wrong to use their ideas unless you give appropriate credit. For example, if you write an essay or paper on the censorship of the press and you structure it using the same set of topics as Pollak uses in his book Sense and Censorship, you should say this in a sentence or note and thus give credit to Pollak.

Example 6: In this essay, the use of censorship against Dorothy Hewett, Terry Hayes, Chris Masters and Brian Toohey will be described.
This means taking the ideas of somebody else and expressing them with different words. Since you are using your own words, you do not need to use quotation marks. However, you must make enough changes so that what you have written is distinctly different, and you must acknowledge your source.

Example 7: Stringent defamation laws combined with tight censorship practices have meant that independent thought has been under attack since white settlement began in Australia (Pollak, 1990, p.7).

Correct.

Example 8: In Australia, stringent censorship and draconian defamation laws have led to the subjugation of thought in Australia throughout the 200 years of White settlement (Pollak, 1990, p 7).

Wrong: this is too close to Pollak’s original wording.

Example 9: Stringent defamation laws combined with tight censorship practices have meant that independent thought has been under attack since white settlement began in Australia.

Wrong: there is no citation of Pollak.

It is often better to avoid paraphrasing altogether and write things in your own words. One good way to do this is to first read the book or article and make brief notes. Then close the book or turn over the article and write what you want to say without looking at the source. In other words, don’t refer to the source material while you are writing, unless you are transcribing a direct quote. Then, afterwards, put in the citations, in the appropriate form and at the appropriate places.

Common Knowledge

It is unnecessary to give a citation to something that is common knowledge. Common knowledge is what ‘everyone knows’ about a particular subject, or which can be found in many sources such as newspapers, magazines, popular journals and radio and television reports.

Example 10: Defamation laws are quite severe in Australia.

Correct: this is common knowledge. No citation is needed.

How to Avoid Plagiarism

Unwitting plagiarism is often the result of poor study methods. The habit of copying verbatim (word-for-word) from a source as you read is dangerous. It is easy to forget that the notes you make are verbatim and to later write them into an essay or report. The only material you should write verbatim are those absolutely delightful, pithy, witty or incisive phrases which you need to make a special point in your essay or report.

The distinction between what needs to be acknowledged and what is common knowledge is not always clear. As you gain experience in expressing yourself, you will learn to discriminate and you will learn the acceptable practices for acknowledgment in the disciplines in which you study. But while you are learning, always play safe and acknowledge, acknowledge, acknowledge.

List of References: