

Earnings Quality and Fundamental Analysis, B8008, Spring 2015

Course Syllabus

I. CONTACT DETAILS

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II. COURSE DESCRIPTION

Financial reporting provides a window into the operational and financial workings of a company. However, translating this information into actionable insights is anything but straightforward. It requires an understanding of Generally Accepted Accounting Principles (GAAP), the quality of financial information, and the adjustments and analyses required to accurately measure and evaluate profitability, exposures, growth prospects, and value. This course is devoted to a systematic study of GAAP and earnings quality, utilizing many actual financial disclosures and cases of accounting abuses. The class also covers standard and not-so-standard financial analysis techniques, and incorporates insights from practitioner and academic research. The primary objective is to acquire a deep understanding of accounting information and how to intelligently use it in making investment, credit, and similar resource allocation decisions. Such knowledge is required of executives, consultants, bankers, analysts, investment managers, and other users of financial information.

The class consists of two parts:

First six class meetings – Review of the financial statements, basic GAAP, earnings quality, earnings management, and ratio analysis. The main objective of this part is to lay out the foundation for the advanced analysis in the second part.

Next eighteen class meetings – For each key line item from the financial statements, we will conduct an advanced level study of GAAP, earnings quality issues, red flags, and related analyses. The focus will be on US GAAP. We will also discuss some differences between US GAAP and International Financial Reporting Standards (IFRS). We will study many real world examples of financial disclosures and accounting abuses.

The course outline below lists the specific topics that will be covered.

III. COURSE ADMINISTRATION

Class Material

The course material consists of a textbook, class notes, cases, practice exercises, problem sets, and optional readings. These items cover all the course content. Reviewing the class notes carefully after class and solving the practice exercises and problem sets will help reinforce the material. This is important especially because for some topics we will not have sufficient class time to discuss all the points and examples contained in the class notes. The optional readings elaborate on some of the analyses and are provided for those interested in research (both practitioner and academic); this material will not be required for the exam.

All items, except the textbook, will be made available electronically before class, saved in an Acrobat version that allows for the addition of comments to the electronic documents. You may use laptop during class to help you follow the discussion, to take notes, or to add comments to the electronic documents as needed (**please use the laptop for those purposes only**). One objective of the class is that you will each obtain a detailed, familiar, and customized (through your additions) set of notes that you will be able to use in your careers.

There will be five assigned problem sets to be handed in:

<u>Problem Set</u>	<u>Class Due</u>
1. Review, ratio analysis, revenue and receivables	TBA
2. Inventory, PP&E, and intangible assets	TBA
3. Investments in debt securities, debt payable, leases, and derivatives	TBA
4. Pension, other postretirement benefits, and income taxes	TBA
5. Investments in equity securities, business combinations, and consolidation	TBA

Class Meetings

<u>Section</u>	<u>Days</u>	<u>Time</u>	<u>Room</u>
B8008-01	M, W	12:30-2:00	WJW 310
B8008-02	M, W	2:15-3:45	WJW 310

Grade

The course grade will be based on **problem sets** (5 problem sets; 5% each, subject to a 20% ceiling), a **project** (30%), and an open-book **Final** exam (50%) (“open books”: including laptop, but laptop use is restricted to accessing electronic copies of course material; no communication or listening devices). Grading of the problem sets will be based on effort only.

Course Project

The project can be either individual or group (up to four participants). Individual projects should be between 4 and 8 pages (including exhibits; single line space). Group projects should be proportionally longer, depending on the number of members. The project can focus on one company or a small group of comparable companies. The analysis should emphasize earnings quality and

fundamentals-related aspects, and should demonstrate a deep understanding of how accounting fundamentals inform on economic performance and value. The structure of the project is flexible. Potential analyses include:

Evaluating the quality of specific accounts and the likelihood and implications of earnings management – for example, “channel stuffing;” “gains trading;” understatement of provisions (e.g., for bad debt or warranty); LIFO liquidation; over-production to inflate reported income; capitalization of operating expenditures; effects of impairment losses; distortions related to accounting for postretirement benefits; business combination gains, losses, and other adjustments; manipulation of income tax reserves and allowances; and the impact of treasury stock transactions on EPS growth.

Adjusting the financial statements to correct or mitigate accounting distortions – for example, capitalizing operating leases; discounting deferred taxes; capitalizing expensed economic investments such as start-up costs, advertising, or research and development; converting the inventory cost flow assumption from LIFO to FIFO; excluding transitory effects from the gross margin (holding gains/losses on inventory, abnormal production); adjusting PP&E-related items for inflation; undoing securitization transactions; undoing the effects of interest capitalization; undoing excess capitalization of expenditures; consolidating significant associates or unconsolidated VIEs/SPEs; distinguishing between operating and financing items (e.g., excess liquid funds, provisions); distinguishing between recurring and transitory income and expense components; adjusting EBITDA for changes in capitalized depreciation; and reclassifying some cash flows in the cash flow statement.

Conducting comprehensive ratio analysis – for example, analyzing profitability; examining measures of overall earnings quality; distinguishing the effects of organic versus acquired growth; forecasting revenue or earnings using fundamental analysis; conducting fundamentals-based risk analysis; and relating value ratios to fundamentals.

Assignment Designation

The project is classified as Type B according to the Columbia MBA Class Assignment Descriptions. This means that you may discuss concepts of the project with other students, but the submitted project must be your own individual (or group) work.

Teaching Assistants

TBA

IV. CONNECTION WITH THE CORE

This course builds on knowledge from the Financial Accounting (B6000) and Corporate Finance (B6300) fixed core courses. These core courses introduce students to basic financial reporting and analysis concepts. In B8008, students acquire a deep understanding of accounting information and how to intelligently use it in making investment, credit, and similar resource allocation decisions. Students should review the concepts studied in B6000 and B6300.

V. RECOMMENDED TEXT

Intermediate Accounting, 15th Edition; Donald E. Kieso, Jerry J. Weygandt, and Terry D. Warfield; Wiley Publishing.

VI. OPTIONAL READINGS (Tentative)

1. Guide to Public Company Auditing. *Center for Audit Quality*.
2. Dichev, I., J. Graham, C. Harvey and S. Rajgopal. 2013. Earnings Quality: Evidence from the Field. *Journal of Accounting and Economics* 56(2-3): 1-33.
3. Arya, A., J. Glover, and S. Sunder. 2003. Are Unmanaged Earnings Always Better for Shareholders? *Accounting Horizons* 17: 111-116.
4. Dye, R., J. Glover, and S. Sunder. 2014. Financial Engineering and the Arms Race between Accounting Standard Setters and Preparers. *Available at SSRN 2508360*.
5. Arya, A., Fellingham, J., Glover, J., Schroeder, D., and Strang, G. 2000. Inferring Transactions from Financial Statements. *Contemporary Accounting Research* 17(3): 366-385.
6. Nissim, D. and S. Penman. 2001. Ratio analysis and equity valuation: From research to practice. *Review of Accounting Studies* 6: 109 - 154.
7. Nissim, D. and S. Penman. 2003. Financial statement analysis of leverage and how it informs about profitability and price-to-book ratios. *Review of Accounting Studies* 8: 531-560.
8. Chan, K., L. Chan, N. Jegadeesh and J. Lakonishok. 2006. Earnings Quality and Stock Returns. *Journal of Business*.
9. Lev, B. and D. Nissim. 2006. The persistence of the accruals anomaly. *Contemporary Accounting Research* 23(1): 193-226.
10. Chan, L., J. Karceski and J. Lakonishok. 2003. The Level and Persistence of Growth Rates. *Journal of Finance*.
11. Nissim D. and A. Ziv. 2001. Dividend Changes and Future Profitability. *Journal of Finance*.
12. Liu, J., D. Nissim, and J. Thomas. 2007. Is cash flow king in valuations? *Financial Analysts Journal* 63(2): 56-68 (2007).
13. Lev, B. and D. Nissim. 2004. Taxable income, future earnings, and equity values. *The Accounting Review* 79(4): 1039-1074.

VII. COURSE OUTLINE

Class¹	Topic	Required Readings	Financial Reports / Accounting and Auditing Enforcement Releases (AAER)	Other Readings
1-3	Review of financial reporting	TBA	TBA	TBA
4-6	Ratio analysis	TBA	TBA	TBA
7-10	Revenue and receivable	TBA	TBA	TBA
10-13	Operating capacity: Inventory, PP&E, intangible assets, other assets	TBA	TBA	TBA
13-17	Fixed claims: Investments in debt securities, debt, leases, derivatives	TBA	TBA	TBA
17-21	Estimated claims: Pension and other postretirement benefits, income taxes, contingencies, other accrued liabilities	TBA	TBA	TBA
21-24	Equity claims: Investments in equity securities, business combinations, consolidation, shareholders' equity, share-based payments, EPS	TBA	TBA	TBA

¹ This column reports the approximate class meetings in which each topic will be discussed.