

## Earnings Quality and Fundamental Analysis, B8008, Fall 2014

### Course Syllabus (Preliminary, as of July 4, 2014)

#### I. CONTACT DETAILS

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Office hours (604 Uris): by appointment

#### 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. We will also review the primary differences between International Financial Reporting Standards (IFRS) and US GAAP, and discuss many real world examples of financial disclosures and accounting abuses.

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

<p>In a review conducted in 2011, the committee for evaluating elective courses concluded that “this is an excellent, carefully constructed course which provides students with valuable insights and lasting concepts.” In the same year, Professor Nissim won the “Dean’s Award for Teaching Excellence” for developing and teaching this course.</p>
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### III. COURSE ADMINISTRATION

#### Class Material

The course material consists of detailed class notes, presentations, practice exercises, problem sets, and optional readings. These items cover all the course content. For those interested in additional readings, Section V provides a text recommendation. A good preparation for each class would be to read the class notes and skim through the presentation. Reviewing the presentation carefully after class and solving the practice exercises and problem sets would 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 and presentations. 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 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	October 8
2. Inventory, PP&E, and intangible assets	October 27
3. Investments in debt securities, debt payable, leases, and derivatives	November 12
4. Pension, other postretirement benefits, and income taxes	December 1
5. Investments in equity securities, business combinations, and consolidation	December 8

#### Class Meetings

<u>Section</u>	<u>Days</u>	<u>Time</u>	<u>Room</u>
B8008-01	M, W	9:00-10:30	Uris 142
B8008-02	M, W	10:45-12:15	Uris 142

First class meeting: *September 3*; last class meeting: *December 8*. Final exam: *December XXX, XXX:00-XXX:00pm*.

#### 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. Finals from previous classes are available on Canvas.

## 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. Examples of projects from previous classes are available on Canvas. 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; and adjusting EBITDA for changes in capitalized depreciation.

***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

Nan Li ([NLi18@gsb.columbia.edu](mailto:NLi18@gsb.columbia.edu))

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#### **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**

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. Nissim, D. and S. Penman. 2001. Ratio analysis and equity valuation: From research to practice. *Review of Accounting Studies* 6: 109 - 154.
4. 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.
5. Chan, K., L. Chan, N. Jegadeesh and J. Lakonishok. 2006. Earnings Quality and Stock Returns. *Journal of Business*.
6. Lev, B. and D. Nissim. 2006. The persistence of the accruals anomaly. *Contemporary Accounting Research* 23(1): 193-226.
7. Chan, L., J. Karceski and J. Lakonishok. 2003. The Level and Persistence of Growth Rates. *Journal of Finance*.
8. Nissim D. and A. Ziv. 2001. Dividend Changes and Future Profitability. *Journal of Finance*.
9. Liu, J., D. Nissim, and J. Thomas. 2007. Is cash flow king in valuations? *Financial Analysts Journal* 63(2): 56-68 (2007).
10. Lev, B. and D. Nissim. 2004. Taxable income, future earnings, and equity values. *The Accounting Review* 79(4): 1039-1074.

## VII. COURSE OUTLINE

Class <sup>1</sup>	Topic	Required Readings	Financial Reports / Accounting and Auditing Enforcement Releases (AAER)	OR <sup>2</sup>
1-3	Review of financial reporting	Chap. <sup>3</sup> #1; Present. #1	<u>Financial reports:</u> Coca-Cola 2010, AXT 2005, Best Buy 2009, Kimberly-Clark 2011, Kellogg 2012	#1, #2
4-6	Ratio analysis	Chap. #2 Present. #2	<u>Financial reports:</u> McDonalds' 2003-2008, Yum Brands 2003-2007, Hewlett-Packard 2003-2008, IBM 2003-2008, Kroger 2003-2008, Caterpillar 2003-2008, Campbell Soup 2009, 3M 2007, Coca Cola 2007, Safeway 2003-2008, CVS 2003-2008, Walgreen 2003-2008, Polo Ralph Lauren 2011, Kimberly-Clark 2011, Kellogg 2012, Nestlé 2012, E.ON 2012, Apple 2008-2012, Comcast 2003-2012, Brinker International 2012, Monsanto 2005-2012	#3-#9
7-10	Revenue and receivable	Chap. #3 Present. #3	<u>Financial reports:</u> News Corporation 2008, Equifax 2008, Sterling Construction 2009, Delta Air Lines 2011 and 2008, Honeywell 2007, Expedia 2008, Amylin Pharmaceuticals 2008, Goldman Sachs 2008, Polo Ralph Lauren 2011, Dresser 2004, Microsoft 2009, Kimberly-Clark 2011, Kellogg 2012 <u>Accounting and Auditing Enforcement Releases (AAERs):</u> Doral Financial 2000-2005, Informix 1994-1997, Bristol-Myers Squibb 2000-2001, Lucent 2000, Nortel 2000-2001, Xerox 1997-2000, Bank of Montreal 2007, Enron 1998-2001, Qwest 1999-2002, WorldCom 2000-2002, Coca-Cola 1998-2002, Suprema 1998-2002, United Commercial Bank 2008-2009, Friedman's, L&H Korea's, GlobeTel 2004-2006, Coca-Cola 1997-1999	
10-13	Operating capacity: Inventory, PP&E, intangible assets, other assets	Chap. #4 Preset. #4	<u>Financial reports:</u> Honeywell 2007 & 2013, Amgen 2008, Deere 2005, Thor Industries 2003-2007, AmerisourceBergen 2006, Goodyear 2009, Polydex 2008, SUPERVALU 2008, Best Buy 2009, Kimberly-Clark 2011, Kellogg 2012, E.ON 2012, Caterpillar 2012, SanDisk 2012 <u>AAERs:</u> Saks Inc. 1999-2002, Nicor 1999-2002, Suprema 1999-2002, WorldCom 2001-2002, Waste Management 1989-1997, Tidewater 2001-2004, America Online 1994-1996, CSK 2002-2005	

<b>Class<sup>1</sup></b>	<b>Topic</b>	<b>Required Readings</b>	<b>Financial Reports / Accounting and Auditing Enforcement Releases (AAER)</b>	<b>OR<sup>2</sup></b>
13-17	Fixed claims: Investments in debt securities, debt, leases, derivatives	Chap. #5 Present. #5	<u>Financial reports:</u> Microsoft 2008, Honeywell 2007, Continental Airline 2008, JPMorgan Chase 2008, Willow 2006, MetLife 2009, AmerisourceBergen 2006, Medco 2005, Goodyear 2009, Southeastern Banking Corporation 2007, SUPERVALU 2008, Kimberly-Clark 2011, Kellogg 2012 <u>AAERs:</u> Morgan Keegan 2007, Adelpia 1999-2001, Fannie Mae 2001-2004	
17-21	Estimated claims: Pension and other postretirement benefits, income taxes, contingencies, other accrued liabilities	Chap. #6 Present. #6	<u>Financial reports:</u> Honeywell 2007, Goodyear 2009, IBM 2010, Boeing 2008, Dow Corning 2005, SUPERVALU 2008, Polo Ralph Lauren 2011, Goodyear 2009, O'Reilly Automotive 2008, Altria 2008, Best Buy 2009, Kimberly-Clark 2011, Kellogg 2012, E.ON 2012, Emerson 2013, Kellogg 2012, Scania 2012, Monsanto 2012, Caterpillar 2012 <u>AAERs:</u> GM 2002, New Composite 1999-2001, ConAgra Foods 1999, Random 1992, Microsoft 1995-1998, Sunbeam 1996-1998	#10
21-24	Equity claims: Investments in equity securities, business combinations, consolidation, shareholders' equity, share-based payments, EPS	Chap. #7 Present. #7	<u>Financial reports:</u> Honeywell 2007, ConocoPhillips 2008, GE 2008, Marriott International 2008, Kimberly Clark 2008, Caterpillar 2008, Alcoa 2008-2009, Chubb 2008, Merck 2008, Best Buy 2009, Kimberly-Clark 2011, Kellogg 2012, Coca-Cola 2010, Assa Abloy 2012 <u>AAERs:</u> Firstmark 1994-1996, Microsoft 1995-1998, Sun 2000-2002, Whitemark 2001-2002, CUC 1995-1997, Fannie Mae 2003, Inamed 1996, UnitedHealth 1994-2005	

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

<sup>2</sup> The list of optional reading (OR) papers is included in Section VI above.

<sup>3</sup> Each chapter contains the related class notes, practice exercises, and solutions.