Earnings Quality and Fundamental Analysis, B7008, Fall 2014

(Preliminary, as of July 4, 2014)

I. CONTACT DETAILS

Prof. Doron Nissim
Email: dn75@columbia.edu
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 three 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 nine 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.

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.
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).

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 four assigned problem sets to be handed in:

<table>
<thead>
<tr>
<th>Problem Set</th>
<th>Class Due</th>
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<tbody>
<tr>
<td>1. Review, ratio analysis, revenue and receivables</td>
<td>October 24</td>
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<tr>
<td>2. Inventory, PP&amp;E, and intangible assets</td>
<td>November 21</td>
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<td>3. Investments in debt securities, debt payable, leases, and derivatives</td>
<td>December 5</td>
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<tr>
<td>4. Pension, other postretirement benefits, and income taxes</td>
<td>December 12</td>
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Grade and Course Project

The course grade will be based on problem sets (4 problem sets; 10% each, subject to a 30% ceiling) and a project (70%). Grading of the problem sets will be based on effort only. The project can be either individual or group (up to four participants). Individual projects should be between 8 and 12 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 EMBA 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**

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**IV. CONNECTION WITH THE CORE**

This course builds on knowledge from the Financial Accounting (B5000) and Corporate Finance (B5300) fixed core courses. These core courses introduce students to basic financial reporting and analysis concepts. In B7008, 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 B5000 and B5300.

**V. TEXT**

VI. OPTIONAL READINGS


## VII. COURSE OUTLINE

<table>
<thead>
<tr>
<th>Class</th>
<th>Topic</th>
<th>Required Readings</th>
<th>Financial Reports / Accounting and Auditing Enforcement Releases (AAER)</th>
<th>OR</th>
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<tbody>
<tr>
<td>1-2</td>
<td>Review of financial reporting</td>
<td>Chap. #1; Present. #1</td>
<td>Financial reports: Coca-Cola 2010, AXT 2005, Best Buy 2009, Kimberly-Clark 2011, Kellogg 2012</td>
<td>#1, #2</td>
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1 This column reports the approximate class meetings in which each topic will be discussed.

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

3 Each chapter contains the related class notes, practice exercises, and solutions.