Financial Statement Analysis and Valuation

Course description and objectives

The purpose of this course is to bring accounting and finance together for business valuation. Financial statement analysis is an integral part of fundamental analysis. This is a course in fundamental analysis. With a stock market bubble and a financial crisis in our recent history, there has been a movement to return to fundamentals, as a way to analyze businesses. The emphasis is on equity and business valuation, with a focus on developing methods for using financial statement analysis to determine value.

This course builds on material in Financial Accounting and Corporate Finance, along with basic knowledge of Statistics. It is expected that the students taking the course will build on their knowledge of financial accounting principles and the knowledge of income statement, balance sheet and cash flows and revenue recognition principles. They will see their accounting knowledge come to life and build on it as they apply it to valuation issues.

As a corporate manager, you need to manage a business to build value. As a value investor, you try to unearth hidden value in the companies that you invest in. An experienced manager and investor both draw heavily on principles of fundamental analysis and carefully crafted valuation methodologies.

The course is organized around the twin themes of understanding and evaluating the financial information reported by firms and coupling it with sound valuation principles. We will focus on understanding and analyzing the principal financial statements and other reports generated by a company. We will learn to critically analyze the information in the company reports and other disclosures and study the implications for valuation.

By the end of the course, the student should be able to perform a thorough, credible investment analysis that meets a high standard. Students should have the ability to estimate fundamental values, and pull apart the information in the financial statements to get relevant information in valuing equities. This course is of interest to those contemplating careers in investment banking (particularly equities), security analysis, private equity hedge funds, consulting, public accounting and corporate finance.

Course materials

I will be largely teaching from my notes that draw from my experience of the last 15 years. The book that I will most closely follow is “Financial Statement Analysis and Security Valuation”, 5th edition, by Stephen H. Penman, Irwin/McGraw Hill Publishing. This book is a good reference, and I will draw from it when I discuss valuation methodologies.

Course notes for each session will be available in advance (on Canvas). A tentative course schedule is attached. I will assume that you have skimmed through the assigned material and worked on the case assignment for the day. Some additional review sessions will be held periodically. You are not required to attend the review sessions, but attendance is encouraged for those who have had difficulty following the class materials and solving assignments. Sharing of course material with someone who is not enrolled in the course or someone who is not in your section is not allowed (both receiving and giving). It would be considered a violation of the honor code (and potentially of copyrights).

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Grading

Your grade will be decided based on a combination of the following:

<table>
<thead>
<tr>
<th>Daily Assignment (Cases) (40% of the grade)</th>
<th>400</th>
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<tbody>
<tr>
<td>Final Exam (60% of the grade)</td>
<td>400</td>
</tr>
<tr>
<td>Project assignment (20% of the grade)</td>
<td>200</td>
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<td><strong>Total</strong></td>
<td><strong>1,000</strong></td>
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Daily case assignments (40% of the grade): The daily (case) assignments are individual assignments. They are Type B assignments. You may discuss with your group but the preparation for submission should be done individually. Grading will be done individually. You will be given these assignments a week in advance. In a typical assignment, you will be asked to read and analyze sections of the financial statements of up to a maximum of three companies and prepare answers to questions for submission. The cases will be discussed in class. Your score will be based on the best 8 assignments submitted.

The final exam (40% of the grade) is the major requirement of the course. It will be held on the last day of the class. It will be a three hour exam. Twenty fours before the beginning of the last class, you will receive a financial statement (10K) of a company. When you come to class on the last day, you will be asked a set of questions based on that company. You will have three hours (class time) to complete your exam and submit your answers. This is a Type C assignment, but you are allowed to discuss the material with others before you come to class.

For the project assignment (20% of the grade), you will do a research project analyzing the financial statements and valuing a company. You will work in a small group. Each group should have not more than 4 people, groups of 3 to 4 are acceptable. This is a Type A assignment and each member of the group will get the same score for the project. You should let me know your group membership by the 3rd session of course. You should also decide on the company that you wish to analyze by the 5th session of the course.

During the course, you will have opportunities to earn bonus points upon fulfilling certain requirements and achievements, which will be announced in class.

I reserve the right to improve any student’s course grade based on my subjective assessment of the student’s contribution to the learning of the class. On the other hand, consistent demonstration of unprofessional behavior might negatively impact a student’s course grade, beyond its impact on class participation.
A tentative course schedule is provided below. Some additional review sessions may be organized, if needed, and you will be informed of the location and duration during the course.

<table>
<thead>
<tr>
<th>Session</th>
<th>Topics, Assignments</th>
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<tbody>
<tr>
<td>Session 1</td>
<td>Introduction to fundamental analysis; basics of firm performance evaluation; and introduction to valuation methodologies (P/E, P/B, EV/EBITDA, DCF, RI models).</td>
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| Session 2 | Introduction to valuation methodologies (P/E, P/B, EV/EBITDA, DCF, RI models)  
**Case:** |
| Session 3 | Analyzing the income statements – how companies report revenues, segment analysis, analyzing margins. Identifying core or sustainable income from reported income. Why is it important? What manipulations are possible? What are the valuation implications?  
**Case:** |
**Case:** |
| Session 5 | Income statement accruals and cash flows. Understanding the structure of the cash flow statement. Major items affecting cash flows. Reformulating the cash flow statement – the treasurer’s view, the investor’s view.  
**Case:** |
| Session 6 | Reformulating the balance sheet for strategic analysis; What is on the balance sheet? What is not? Impact of working capital on cash flows.  
**Case:** |
| Session 7 | Balance sheet analysis; Capex, investments. Understanding the information in the MD&A, footnotes and other sources of information. What are the drivers of capex? How to think of the cash flows for Capex?  
**Case:** |
**Case:** |
| Session 9 | Analysis of debt. Understanding the need and capacity for debt. Introduction to credit analysis.  
**Case:** |
**Case:** |
| Session 11 | Understanding P/B ratios. Review of valuation models. Putting it all together to determine fundamental values and firm analysis.  
**Case:** |
| Session 12 | **FINAL EXAM** |