MBA 634
Advanced Financial Statement Analysis II
Bryan School of Business and Economics
UNC-Greensboro

Professor Tony Wingler
Spring (Module 2) 2005
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Course Description:

FSA II extends the coverage of the first module (FSA I) by providing:

- forecasting refinements to simple forecasts (SF1, SF2, and SF3);
- understanding of the relationship between Price-to-Book and Price-Earnings valuation measures;
- understanding that liberal/conservative accounting policies do not bias valuations under certain conditions and means of identifying where necessary conditions are violated and forecasting adjustments required to achieve quality valuations;
- refinements to measuring risk from both an investor's and creditor's perspective.

Course Objectives

- Develop full-information forecasting techniques as complement to SF1, SF2, and SF3 forecasts to provide more informed forecasts and valuations;
- Understand key drivers of Price/Earnings ratios and Price/Book ratios;
- Identifiers of conservative/liberal accounting policies and the implications for forecasting and valuation;
- Understand and identify steady-state and non-steady-state conditions and the implications for developing full-information forecasts and valuations;
- Credit analysis as compared to equity valuation

Course Materials

- The primary reading material for the module is chapters 15-19 of Financial Statement Analysis and Security Valuation by Stephen Penman, published by McGraw-Hill.

- We will make extensive use of chapter exercises and mini-cases in the Penman text. This material is on the website: www.uncg.edu/bae/people/wingler . Additionally, we will use the second part of the BYOAP.xls software to conduct the full-information forecasting and valuation, which is the culmination of this module.

Course Format

The course format will be lecture/discussion of assigned sections of the Penman text supplemented with exercises and discussions of mini-cases to reinforce understanding. Students will extend the analysis of their firm from FSA I by adding the various refinements covered in this module. To encourage timely attention to these refinements, completion of the various sections will serve as homework assignments.

Course Grading

The course grade will be based on homework assignments (see syllabus) which entail applying various sections of the full-information forecasting and valuation process covered in this module to extend the analysis of your firm in FSA I. These assignments will constitute fifty percent of your grade. The remaining fifty percent of the grade will be based on a paper which presents the results of the various refinements and provides a full-information valuation of your firm.

See description of course project for more details

Homework----30%---explained in detail in separate description of To Dos.
Weaver Portfolio Decision----20%
Full-information forecasting and valuation---50%

Weaver Portfolio

The class will recommend additions/deletions to the Weaver Portfolio. Each group will present their views on adding the firm analyzed to the portfolio. Additionally, each group may recommend one additional firm for inclusion in the portfolio As always, the Weaver Portfolio is fully invested and in order to buy we must decide what to sell. You will be provided the current composition of the portfolio. We will do this during the eight class period in the manner of MBA 631.

Class Attendance and Involvement

At this stage of your graduate study you understand that the process requires mutual investment by your professor and you. Class attendance and involvement is central to the learning experience and I rely on you to conduct yourself in the responsible manner evidenced by the great majority of our students. Excessive absences will result in a one grade reduction at a minimum.

Session 1

Required reading: Review/reread Chapters 13-14 in Penman---the last two chapters covered in FSA I.

We will review this material and focus on:

- The drivers of RNOA and ROCE---Chapter 13

- From Chapter 14:
    - SF1---perfect balance sheet capturing all relevant aspects of valuation which means we can value a firm based on its book value
    - SF2---where balance sheets are not perfect, we link the balance sheet and the income statement (residual earnings) to value equity or the firm (operations)
    - SF3--- same as SF 2 but residual earnings are anticipated to grow at constant rate beyond our forecast period. As you will come to understand, this situation begs the issues of steady-state forecasting which is addressed more fully in this module.

Our simple forecasts provided the basis for the valuation of your firm in FSA I. Though limited, the simple forecasts provide important benchmark and a basis for refining our forecasts and valuation.

Chapter 15 in Penman

FSA I relied on historical data to develop simple valuations. Chapter 15 lays the foundation for forecasting to develop what we term full-information forecasts. As always, insightful forecasting rests on understanding the business and its environment. In forecasting, a central question is how strongly to rely on a firm's recent performance in developing a forecast? The chapter makes the point that for reasons of competition and business dynamics, firm regress to mean over time: good firms decline and bad ones improve or go out of business. This understanding enables the analysts to formulate better forecasts, especially where they are of a longer term nature.

You can find the following material on the web site:

Exercises: E15.1, E15.2, E15.3
Mini-cases: M15.1, M15.2, M15.3

The discussion/lecture of Chapter 15 here will likely flow over to our second meeting

Session Two

Chapter 16 in Penman

Accounting policies (conservative/liberal) can produce key driver measures: RNOA, ROCE, etc. which are reflections of the accounting and not true economic value. The analyst strives to distinguish between real value creation/destruction as compared to the appearance of such resulting from the accounting. The good news is that accounting polices do not bias residual income valuations if forecasts capture steady-state conditions. LIFO inventory valuation is one example of where accounting treatments can create value and should be considered in conducting valuations.

Chapter Exercises: E16.1, E16.2, E16.3
Mini-case: M16.1
These materials are on the website

Session Three

Submit project work (To Do #1) for Chapters 15 (see description of course project for details)

Chapter 17 in Penman

Chapter 17 deals with the effects of accounting policies that are temporary in nature, thus making current profitability a poor indicator of future profitability. From Chapter 17 we understand that a permanent accounting policy, either liberal or conservative, does not pose a problem for forecasting and valuation (except for LIFO reversing) However, if a firm temporarily employs an accounting policy to boost or depress earnings, its recent earnings provides a poor basis for forecasting. The goal in Chapter 18 is to understand how to conduct a quality of earnings analysis to provide insights about the extent to which earnings are manipulated by accounting methods and thus provide a questionable basis for forecasting. Based on the quality of earnings analysis, the analyst is better informed about how to modify profitability measures in their forecasts.

Also see Concept Questions in separate file

Chapter Exercises: E17.2, E17.3, E17.4, E17.5, E17.6

Mini-cases: M17.1, M17.3, M17.4

These materials are available on the website.

Session Four

Submit To Do # 2 for Chapters 16

Preliminary report on groups' thoughts on recommendations for Weaver Portfolio. This is informal, no written assignment.

Chapter 18 in Penman

A firm's risk profile drives the discount rate used in valuing the firm and its equity. The most practical means of reflecting risk in forecasting is to construct scenario analyses. Scenario analyses involve changing the values of key determinants of value: RONA, ATO, Margins, etc. and measuring the impact on the value of the firm or value of the equity . A small amount of scenario analysis can provide important insight about the risk posed by the firm under plausible circumstances and it will be the approach we'll use here. We focus on the full-information forecasting tab in Roadmap.xls to conduct scenario forecasting/valuation analyses. See next page for exercises.

Chapter Exercises: E18.1, E18.2, E18.3, E18.4 (see website)

Session Five

Submit To Do #3 for Chapter 17

Carryover of Chapter 18 as required, if so, To Do For Chapter 17 due next week

Discussion Case distributed in class: Enron Red Flags. This case gives some good background on the Enron situation which resulted in the most infamous bankruptcy (implosion) in U.S. business history. The contextual question for us is whether a modest analysis of the firm's financial should not have indicated that something major was wrong? If so, why was the obvious overlook resulting in the final sad story.

Session Six

Submit To Do #4 for Chapter 18

Chapter 19 in Penman

Here we change our focus from valuing the firm from an investor's perspective to viewing it from a creditor's perspective. The good news is that the way we've reformulated financial statements can be modified slightly to address its credit risk.

Chapter Exercises: E19.1, E19.2, E19.3
Mini-case: M19.1

The To Do's for Chapter 19 (credit analysis) will not be collected as a homework assignment. Instead, please include your credit analysis for your firm in the final paper summarizing your full-information forecasting.

Session Seven

This will be a catch-up and paper clarification session. We'll use the time to deal with previous topics and discussion which may need reinforcement. We can also use this session to discuss various aspects of your papers that concern you.

Session Eight

Catch up and wrap up, submit full-information forecasting/valuation paper and formulate Weaver Portfolio decision. Submit evaluation of group members