

Financial Statement Analysis

Tentative Outline

Lecturer

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Course Dates

May 3rd : 08:15 – 11:00

May 6th : 08:15 – 12:30

May 13th: 08:15 – 12:30

May 17th : 08:15 – 11:00

May 20th : 08:45 – 11:30

Introduction

The purpose of the financial statement analysis course is to provide students with an advanced understanding of the financial reporting process and expand their ability to extract relevant information from accounting data. The course will cover advanced issues in financial statements including financial ratio analysis, assessing earnings quality, and basic issues in valuation. The course is based on cases and academic papers.

Topics:

A. Financial Ratio Analysis

Introduction and Background

Financial ratios are perhaps the most common tool in financial statement analysis. They are used for summarizing financial data, analyzing current performance and financial position, and comparing performance and financial position across companies and over time. Investors, lenders, rating agencies and regulators use them to analyze company performance, strategy and risks. The course will cover the following financial ratios: profitability, activity, liquidity, leverage, and market related (valuation) ratios. We will analyze the DuPont Decomposition of return on equity and return on net operating assets.

Harvard Business School cases:

- Unidentified Industries;
- Introduction to Financial Ratios.

Textbook: Penman CH: 8-11

Academic papers:

Lev, B. and S.R. Thiagarajan, 1993. Fundamental information analysis. *Journal of Accounting Research* 31: 190-215.

Nissim, D. and S.H. Penman. 2001. Ratio analysis and equity valuation: From research to practice. *Review of Accounting Studies*, 6, 109-154.

Amir, E., I. Kama, and J. Livnat. Conditional versus unconditional persistence of RNOA components: implications for valuation. *Review of Accounting Studies* (Forthcoming, 2011).

B. Earnings Quality and Earnings Management:

Introduction and Background

The practice of earnings management has been discussed and documented extensively in both the academic and practitioner's literatures. The academic literature has studied earnings management through the manipulation of discretionary accruals, real transactions, or both. Two related indicators of earnings management frequently referred to are: (i) cash does not follow earnings and/or revenues, and (ii) accruals do not correspond to earnings and/or revenues. Earnings management typically has a negative connotation, though, in certain cases, it might be an activity that is rewarded by investors. A special case of earnings management is income smoothing; some practices of income smoothing have been argued to be desirable.

Textbook: Penman CH: 16-17

Academic papers:

Dechow, P.M., R. Sloan, and A. Sweeny. 1995. Detecting earnings management. *The Accounting Review* 70(2): 193-225.

Graham, J. R., C. R. Harvey, and S. Rajgopal. 2005. The Economic Implications of Corporate Financial Reporting. *Journal of Accounting & Economics* 40: 3-73.

Cohen, D., A. Dey, and T. Lys. 2008. Real and Accrual Based Earnings Management in the Pre and Post Sarbanes Oxley periods. *The Accounting Review* 83: 757-87.

Dechow, P.M., W. Ge, and C.M. Schrand. 2010. Understanding earnings quality: A review of the proxies, their determinants and their consequences. *Journal of Accounting and Economics* 50: 344-401.

C. Basic Valuation Issues

Case: Home Depot

Textbook: Penman CH: 3-6 13-15

Textbook: Penman, S.H. 2010. *Financial Statement Analysis and Security Valuation* (4th Ed.) McGraw Hill.

Assessment: Course grade will be determined by cases (personal assignment) and final assignment (group assignment).