

ACCT 742
Problems in Financial Reporting
Fall 2007 SYLLABUS -- Preliminary

Professor Richard Lambert
lambertr@wharton.upenn.edu

Office: 1307 SH-DH
Phone: 898-7782

Course Overview

Financial statements are a primary means for firms to communicate information about their performance and strategy to investors and other groups. In the wake of numerous accounting scandals, it is more important than ever for managers and investors to understand (i) the financial reporting process, (ii) what financial statements do and do not contain, and (iii) the types of discretion managers have in presenting transactions they have undertaken. This course is designed to help you become a more informed user of accounting numbers by increasing your ability to extract, interpret, and analyze information in financial statements.

We will focus on many of the biggest problem areas of financial reporting:

- The Financial Reporting Environment Post Enron
- Earnings Quality
- Cash Flow Quality
- Alternative Measures of Profitability
 - GAAP, Pro Forma, EBITDA, and the FASB's proposed new performance statement
- Earnings Per Share and Dilution
 - GAAP dilution vs Economic Dilution
- Revenue Recognition
- Fair Value and Mark to Market
- Derivatives
- Stock Options
- Intangible Assets
- Pensions
- Consolidation of Debt and "Off Balance Sheet" Debt
- Special Purpose Entities and Control
- Multinational Reporting – Currency Changes
- Segmental Reporting
- Income Taxes
- Distress Prediction Models
- Sarbanes Oxley and Upcoming Financial Reporting Issues

While this is not a course in equity valuation *per se*, equity valuation is one of the most common uses of financial statement data. Accordingly, we will examine the relation between

stock prices and financial statement information. We will also study the use of financial ratios and forecasted financial statement data in models of distress prediction.

The course assumes a solid understanding of basic financial accounting (at the level of Acct 620/621).

Course Materials

Bulkpack The bulk pack is available at Wharton Reprographics. In addition, virtually all of the material will be available in the eRoom for Acct 742 on Web Café.

Text: Revsine, Collins, Johnson, *Financial Reporting and Analysis*, 3rd ed., Prentice Hall, 2005. This text serves as a reference on accounting and disclosure topics. Note that the course is not a textbook-based course. Text readings provide supplementary information and information useful for preparing the problems and cases.

In-class handouts: Occasionally, supplemental material will be distributed in class. You will be billed for these handouts by the university at the end of the semester. Note that any lecture slides will not be distributed in class. Please download these prior to class.

Web Café The course has a room on Web Café that you can log onto with your User name and Password. Within the Course Material folder, there is a folder for each class session, as well as one for the syllabus and the exams. Inside the folder for a given class session, you will see three or four subfolders:

Bulk Pack Material: This includes notes, problems, cases, and readings that were included in the bulk pack.

Practice Problems: Additional (optional) Problems and Solutions to help get ready for class assignments and exams

Pre Class Material: New readings, problems, and cases (ones not included in the course pack) are contained here. This folder will also have any spreadsheets available to help work the problems and cases. Finally, this folder will contain power point slides that will constitute the outline of what we'll cover in class that day. Many students find that printing out the slides before class helps them follow along better. Two to three slides per page is a good compromise between not using up too much paper and having room to jot down notes.

Solutions and Post Class Material: This is where I'll post solutions, corrections, etc

Office Hours

Feel free to call with questions or contact me via email at the address above. E-mail is often an easier and quicker way to get your questions answered.

Office Hours: Monday and Wednesday 12:00 – 1:15pm

Grading and Course Requirements

Your grade for the course will be determined on the basis of :

Class Participation	20 %
Individual Case Write Ups (3 best)	25 %
Group Project	25 %
Individual Final Exam	<u>30 %</u>
Total	100 %

Class Participation

The amount of learning that takes place in the course will depend on how active the class discussions are, which is dependent on the amount of preparation you do before class. Class participation will be based on your contribution to the class discussions and analyses, not simply on the amount of time you talk. If necessary, I will cold call students.

Because entering or leaving the classroom during class time is disruptive to the learning environment, your fellow classmates and I expect that you will not do so, except in an emergency.

Please bring to each class a Name Card, with your name printed in **LARGE DARK LETTERS**. This will facilitate my getting to know your names and my ability to reward you for class participation.

INDIVIDUALLY DONE Case Write Ups:

Each student is required to write-up answers to 3 of the cases we will be covering in class.

If you want to hand in answers to more than 3, I will count the 3 best cases. Cases must be handed in at the beginning of the class session. Cases will be graded on the basis of effort and completion along with accuracy. Cases are to be done INDIVIDUALLY.

Making use of suggested case solutions from prior years or copying the case write-up of anyone else will constitute cheating and could result in receiving an F for the course.

Case write-ups will be returned promptly. I recommend you wait till your first case write up is graded and returned before you submit your second.

Certain Cases are not allowed to be turned in as part of this requirement. These are noted below as well as in the day-by-day assignments contained later in the syllabus.

Cases Not Allowed to be turned in:

Session 1	Introduction	Enron
Session 10	Derivatives	Global Candy Company
Session 25	Summary	No Case is assigned for this day

Also note that in Session 3, there are two Statement of Cash Flow Cases

Alpha and Beta and Epsilon and Omega
Pick one of them -- You can't turn in both of them!

Finally, note that in Session 6, Revenue Recognition, there are two cases listed:

Yahoo vs Google and Merck
Either turn in neither of them or BOTH of them – but not just one (neither is very long)

Group Project:

Your group must identify a firm that has been the subject of an accounting controversy (alleged or real). You can use internet search engines to help you pick your firm, SEC actions, etc. Choose a firm and accounting issue you are interested in.

Groups can be composed of up to 4 students. Groups may contain a mixture of students from my two sections. Group composition must be finalized by October 10 (just before Fall Break starts). In addition each group must obtain approval for the company they're going to work on by October 10. The earlier you decide on a company, the more time you'll have to work on it.

Group Projects must be turned in by Monday November 12 at 3:30 pm

Please do not choose Enron, Sunbeam, Worldcom, Microstrategy, Computer Associates, or AOL. Moreover, do not choose any firm and their accounting controversy that we will be covering in class. For example, it's perfectly OK to pick a firm that has been found to have pension accounting, but don't pick American Airlines – because that's the pension case we'll be doing in class.

Once you have identified a firm and its accounting controversy, send me an email letting me know who and what you've selected. Include a brief statement for what you believe the accounting issues for that firm are. An article from the financial press describing the controversy would probably work here. If I feel the firm/controversy is inappropriate, not complex enough, or too complex, I will veto it.

More details will be provided during class and on the course web page.

Final Exam

The final exam will be a take-home exam. **You must work on the exam individually.** You are not permitted to discuss the exam with anyone else, including other students, former students, or people in the real world. However, you are permitted to use any written resource, such as your notes, the textbook, information on the company you find on the web, etc. As above, violations of these procedures will constitute cheating and could result in receiving an F for the course.

The final exam is a take home that will be distributed during final exam week. You will have up to 72 HOURS to work on the exam, and **you can choose which 72 hour period during final exam week to work on it.**

More details on the exam will be provided as the time gets closer.
Sample questions and solutions will be available from Web Café.

Grading Disputes

All grading disputes must be appealed within *two calendar weeks* following the return of the assignment or exam (unless otherwise noted). *A request for a regrade will not be considered if it is submitted more than two week after the return of the assignment or exam (or after the specified deadline).* To have an assignment or exam regraded, you must submit the original (with no modifications) and a written description of your disagreement with the initial grade.

Preliminary Course Outline

<u>Session</u>	<u>Date</u>	<u>Topic</u>	<u>Problem/Case</u>
1	Wed Sept 5	Introduction and The Post-Enron Financial Reporting Environment	Enron – not allowed to be turned in
2	Mon Sept 10	Accounting Earnings Quality	Corbomax
3	Wed Sept 12	Cash Flow Quality	SCF Classification- turn in at most one Alpha and Beta SCF - Epsilon and Omega
4	Mon Sept 17	Alternative Measures of Profitability	Millennium Pharmaceuticals
5	Wed Sept 19	Earnings Per Share and Dilution	Ciber Inc
6	Mon Sept 24	Revenue Recognition – Gross versus Net and Multiple Deliverables	Merck; Yahoo vs Google – either turn in none or both, but not just one
7	Wed Sept 26	Revenue Recognition and Uncollectibles	Patten
8	Mon Oct 1	Securitization	H&R Block
9	Wed Oct 3	Fair Value Accounting – Gains and Losses	Astoria
10	Mon Oct 8	Derivatives	Global Candy Company – not allowed to be turned in
11	Wed Oct 10	Risk Disclosures	Sun Microsystems
	Mon Oct 15	NO CLASS – FALL BREAK	
	Wed Oct 17	NO CLASS – FALL BREAK	
12	Mon Oct 22	Stock Option Accounting	Google
13	Wed Oct 24	Valuing Stock Options	Valuing a Stock Option
14	Mon Oct 29	Intangible Assets	Sun Microsystems
15	Wed Oct 31	Intangible Assets II	Nike
16	Mon Nov 5	Long Term Debt – Market vs Book Values	MGM
17	Wed Nov 7	Pensions and OPEB	American Airlines
18	MON Nov 12	** GROUP PROJECT DUE **	
18	Mon Nov 12	Consolidations	Coca-Cola
19	Wed Nov 14	SPE's and Variable Interest Entities	Alza
20	Mon Nov 19	Multinationals and Foreign Currency Translation	Machinery International
21	Wed Nov 21	NO CLASS	
22	Mon Nov 26	Segmental Reporting and EVA	Pepsi
23	Wed Nov 28	Income Taxes and Fin 48	TBA
24	Mon Dec 3	Risk Analysis and Prediction	Sun Microsystems
25	Wed Dec 5	Sarbanes Oxley and Course Summary	None

FINAL EXAM WEEK is from Wednesday December 12 to Wednesday December 19

Preliminary Schedule of Assignments

RCJ: refers to Revsine, Collins, Johnson, *Financial Reporting and Analysis*, 3rd ed.

Session	Date	Topic
1	Wed Sept 5	Introduction and The Financial Reporting Environment Post Enron
	Read:	“The Corporate Scandal Sheet” “The Rise and Fall of Enron” “Timeline of the major Enron-related events” “Timeline of key events leading to Andersen demise” “An Enron Primer” “The Formula: Enron, Intelligence, and the Perils of Too Much Information” “Excerpts from Report of Neal Batson, Court-Appointed Bankruptcy Examiner”
	Prepare:	Enron: What did Enron do to manipulate the appearance of their financial performance and financial condition? Why did they do these things? (not allowed to be turned in)
2	Mon Sept 10	Accounting Quality
	Read:	RCJ: Chapter 2 pp. 41-70, ; Chapter 5, pp. 126-137 Class Notes on Accounting Changes MD&A: Revealing The Soft Numbers Increased SEC Aggressiveness in Investigations and Enforcement Actions
	Prepare:	Corbomax
3	Wed Sept 12	Cash Flow Quality
		RCJ: Chapter 17 RCJ: Chapter 4, pp. 174-185 RCJ: Chapter 6, page 301 Class Notes on Cash Flow Statement Cash Flow Never Lies, Or Does It? How Comcast Does Its Counting – ‘Cash Flow’ Looks Better Using Non-GAAP Metric Cash Flow? It Isn't Always What it Seems Testimony of Richard Roach on Enron Prepays
	Prepare	Statement of Cash Flow Classification Case – Alpha and Beta SCF Case II – Epsilon and Omega (turn in none or one of these, but not both)

4	Mon Sept 17	Alternative Definitions of Profitability
	Read:	<p>RCJ, Chapters 1 and 2 (Skim both)</p> <p>Class Notes on Alternative Definitions of Earnings A Clear Look at EBITDA The Evils of EBITDA EBITDA's Foggy Bottom Line Top 10 Limitations of EBITDA</p> <p>Out, by \$100 billion - How Pro Forma Accounting Boosts Profits New SEC Requirements For Pro Forma Statements and Annual Reports Lies, Damn Lies, and Pro Forma Non-GAAP Measures- Love Them or Hate Them? Pro Forma Numbers Are Alive and Well Stock Options, Meet Pro Forma</p> <p>“One Statement or Two?” Tabled by FASB Profit As We Know It Could be Lost With New Accounting Statements Financial Statement Presentation – Excerpts From Current Status of Joint FASB – IASB Project</p>
	Prepare:	Millennium Pharmaceuticals

5	Wed Sept 19	Earnings Per Share and Dilution
	Read:	<p>RCJ Chapter 15 Class Notes – Dilution and Earnings Per Share</p> <p>Dilution of Employee Stock Options New EITF Pronouncement Aims to Close CoCo Loophole Ciber Declares it will Settle at least 30% of its Convertible Debt in Cash Helps Mitigate FASB Stance Ciber's Money Where Its Mouth Is Move Over CoCo's: Net Shares Will Do</p>
	Prepare:	Ciber, Inc – Stock Options, Convertible Debt, and Dilution

6	Mon Sept 24	Revenue Recognition
	Read:	RCJ Chapter 2, pp. 45-51 Revenue Recognition Remains Accounting's 800-lb Gorilla Gross versus Net Presentation of Revenue Xerox Settles SEC Enforcement Action Charging Company with Fraud Creative Accounting.com Yahoo, Google, and Internet Math
	Prepare:	Yahoo versus Google Merck (turn in none or both of these – but not just one!)

7	Wed Sept 26	Revenue Recognition and Uncollectibles
	Read:	RCJ Chapter 3 (especially pp. 117—125) RCJ Chapter 8, pp. 383-395 Class Notes on Revenue Recognition Installment Method – An Example Revenue Recognition and the Collection of Cash Accounts Receivable – Gross vs Net and the Cash Flow Statement “Hot Air Accounting,” Forbes, May 5, 1997, pp. 114-115.
	Prepare:	Patten Corp. (see spreadsheet on course web page)

8	Mon Oct 1	Securitizedizations
	Read:	RCJ: Chapter 8: pp. 396-405 Class Notes on Transfers of Financial Assets Examples of Securitizedizations: Calculation of Gains and Losses American Securitizedization Forum: Testimony Before Congress Excerpts from Deloitte and Touche: Securitizedization Accounting Scandal: Subprime Meltdown; Securitizedization Accounting Subprime Mess Fueled By Crack Cocaine Accounting Subprime Lessons H&R Block Unit Earnings Up 34% Mortgage Lending Boosts H&R Block Profit 16%
	Prepare:	H&R Block

9	Wed Oct 3	Fair Value Accounting
	Read:	<p>RCJ: Chapter 11, pp. 563-579; Chapter 16, pp. 885-891</p> <p>Class Notes on Accounting for Investments in Debt Securities and Small” Equity Investments Shining a Light on Companies Accounts Fair Value Measures Fair Value Accounting It’s Time to Get Real About Realizations</p> <p>“FASB’s New Draft on Values: Good News and ...” “Standards & Poor’s Comments on FASB’s Proposed Statement on Optional Fair Value Reporting” Show Business – A Blockbuster Deal Shows How Enron Overplayed Its Hand The Adventures of Enron, Blockbuster, and Me Enron’s Mark to Market Adventures</p> <p>Historical Cost Vs Fair Value of a Bond</p>
	Prepare:	Astoria Financial (see spreadsheet on course web page)

10	Mon Oct 8	Derivatives
	Read:	<p>RCJ: Chapter 11, pp 585604 Class Notes On Hedging and Derivatives</p> <p>Derivative Wars Goldman Sachs’ Report on Porsche (skim) EDS Isn’t Alone in Betting on a Rising Stock How EDS Rolled Dice -- and Lost --- Effort to Prevent Option Grants From Diluting Per-Share Profit Backfires When Stock Plummets</p>
	Prepare:	Global Candy Company (not allowable to be handed in)

11	Wed Oct 10	Derivatives and Risk Disclosures
	Read:	SEC-Market Risk Disclosures: Enhancing Comparability (concentrate on pp. 62-67) Value at Risk Lost in the Maze This Much Is Clear: FAS 133 Needs To Go Freddie Mac Swings to \$211M 1Q Loss On Derivatives Freddie Execs Manipulated Acctg To Smooth Earnings FACTBOX – Fannie Mae accounting scandal, earnings restatement Fannie Mae Says It Expects to Spend Over \$1 Billion This Year on Accounting Review
	Prepare:	Sun Microsystems

	Mon Oct 15	NO CLASS – FALL BREAK
	Wed Oct 17	NO CLASS – FALL BREAK

12	Mon Oct 22	Stock Option Accounting
	Read:	RCJ: Chapter 15, pp. 836-854 Class Notes on Employee Stock Options , Dilution, and Notes on Earnings Per Share “Basic Principles in the New Accounting for Stock Options” “Accounting for Stock Options” “For the Last Time – Stock Options are an Expense” “Buffet vs Grove” “Cisco’s Bold Idea” “Focus in Apple’s Option Scandal Shifts to Board”
	Prepare:	Google Inc

13	Wed Oct 24	Valuation of Employee Stock Options
	Read:	"The Best Way of Valuing Options," Business Week, July 30, 2002 “New Valuation Model could dampen the controversy over expensing employee stock options” "Deciding Value of Stock Options May Be Tricky --- Lack of Universal Method For Determining Amount Poses Dilemma for Firms," The Wall Street Journal Europe, August 7, 2002. “Using the Black Scholes Model” “How To Excel at Option Valuation” “Cisco’s Stock Option Valuation 2006” “Google Creates Options Market” “Are TSO’s A New Trend?”
	Prepare:	Valuing an Employee Stock Option (see spreadsheet on course web page)

14	Mon Oct 29	Intangible Assets
	Read:	RCJ: Chapter 10, pp. 520-527 “Valuing Intangibles: A Primer” “In-Process R&D Charge Offs: The Bad And The Ugly” “In-Process R&D in Business Acquisitions” “A Primer on Goodwill Impairment” “Corporate writedowns may hit \$1 trillion”
	Prepare:	Sun Microsystems (might be changed – consult course web page)

15	Wed Oct 31	Intangible Assets
	Read:	“Measuring the Intangible Assets of a Firm” “The Top 100 Brands”
	Prepare:	Nike

16	Mon Nov 5	Long Term Debt – Market vs Book Values
	Read:	RCJ: Chapter 15, pp. 854-859 Kirk Kerkorian’s Personal Money Machine Convertibles: Get Ready to Leverage Up Accounting for Convertible Debentures – Example Problem Accounting for Convertible Debentures – Solution
	Prepare:	Metro-Goldwyn-Mayer

17	Wed Nov 7	Pensions and OPEB
	Read:	RCJ Chapter 14 Class Notes on Pensions Notes: New Changes in Pension Accounting Bush Signs New Bill to Keep US Pension Plans Afloat Pensions Likely to Stay a Dying Breed FASB Addresses Pensions Pensionphobia Strikes Again Displaying the Funding Status of Postretirement Plans Pension Accounting - An Example Pension Accounting - Solution
	Prepare:	American Airlines

MONDAY – NOVEMBER 12 – GROUP PROJECTS DUE BY 3:30 PM in Accounting Suite (SH-DH 1300)

18	Mon Nov 12	Intercompany Investments and Consolidation
	Read:	RCJ: Chapter 16, pp. 891-909 Class Notes on Business Combinations Class Notes on Goodwill and Noncontrolling Interests Mishmash Accounting Goodwill and Noncontrolling Interests in Acquisitions
	Prepare:	Coca-Cola (also see spreadsheet from Course Web Page)

19	Wed Nov 14	SPE's and Joint Ventures
	Read:	"From SPE's to VIE's" "Is it Time to re-look at the fundamentals of SPE's?" "Reining In SPEs: New rules for special-purpose entities may result in bigger corporate balance sheets," CFO Magazine [CP]
	Prepare:	Alza Corporation

20	Mon Nov 19	Multinationals and Currency Rate Fluctuations
	Read:	Class Notes on Foreign Currency As Exchange Rates Swing Carmakers Duck Natural Performers
	Prepare:	Machinery International

21	Wed Nov 21	NO CLASS
	Read:	Enjoy Your Thanksgiving Break
	Prepare:	

22	Mon Nov 26	Segmental Reporting and EVA
	Read:	Class Notes on Segmental Reporting (SFAS 131) Class Notes on EVA as a Performance Measure At last! The light at the end of the corporate performance tunnel
	Prepare:	Pepsico Inc and Economic Value Added (B) [CP]

23	Wed Nov 28	Income Taxes
	Read:	RCJ: Chapter 13 Class Notes on Income Taxes Understanding the Tax Footnote Income Tax Cheat Sheet Accounting for the Income Tax Consequences of Share based Compensation Tech Titan's Tax Picture is Clouded by Options Fin 48: Standing Naked Before the IRS Moody's: New FASB Guidance On Tax Uncertainties To Help Find Exposures
	Prepare:	TBA

24	Mon Dec 3	Risk Analysis and Prediction
	Read:	RCJ: Chapter 6, pp. 298-300 Penman: Chapter 21, The Analysis of Credit Risk [CP] "A Yardstick for Corporate Risk Current measures of a company's health--and its ability to handle adversity--are inadequate. Here's what we need to know," Business Week, August 26, 2002. [CP] Excerpts from Moody's Default Ratings Models Sun Posts \$2.3 bn loss
	Prepare:	Sun Microsystems [CP]

25	Wed Dec 5	Summary and Sarbanes-Oxley
	Read:	Two Years Later – A Recap of The Sarbanes-Oxley Act of 2002 And Related SEC Rulemaking Japan Regulators To Require U.S.-Style Reporting Standards SOX 404 – Unintended Consequences and its Impact on Small Business (skim only) Sarbanes-Oxley has been a pretty clean sweep ; Most agree it's a big success Sarbox Isn't Really Driving Stocks Away Politics & Economics: Sarbanes-Oxley Audit Rules Likely to Ease IFRS: Coming to America The Top 10 Reasons to Fix the FASB's Conceptual Framework
	Prepare:	NONE

		FINAL EXAM (Open Book - Open Notes)
		<p>You can pick it up anytime beginning the first day of Final Exams Week and you have 72 hours to turn it in. All exams must be turned in by 3 pm on the last day of final exams week.</p> <p>Final Exam Week is from Wednesday December 12 through Wednesday December 19</p>