

ACCT 742
Problems in Financial Reporting
Spring 2009 SYLLABUS -- Preliminary

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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 International Financial Reporting Standards

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, Mittelstaedt, *Financial Reporting and Analysis*, 4th ed., Prentice Hall, 2007. 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 %
Midterm Examination	20 %
Group Project	25 %
Individual Final Exam	<u>35 %</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.

Midterm Exam:

The Midterm Exam is scheduled for Wednesday February 25th.

It is an open book-open notes exam.

The Midterm Exam will cover material covered in class through Monday February 23rd.

More details on the exam will be provided as the time gets closer.

Sample questions and solutions will be available from Web Café.

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 March 2 (just before Spring Break starts). In addition each group must obtain approval for the company they're going to work on by March 2. The earlier you decide on a company, the more time you'll have to work on it. I strongly encourage you to form your teams sooner than this and to get started on your project before this date as well.

Group Projects must be turned in by Monday March 30th 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.

It's perfectly fine to pick a non-US company for your project.

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 are provided below, and additional information will be provided during class and on the course web page.

First, find a company that has been criticized or investigated for some questionable *accounting practice*.

- Good places to search include popular press articles, analysts reports, or the SEC accounting enforcement page (<http://www.sec.gov/divisions/enforce/friactions.shtml>)
- Do *not* choose Enron, WorldCom, AOL, Sunbeam, or Microstrategy.
- Make sure that you choose a firm with questions about its accounting practices rather than a firm that has committed outright fraud. For example, a firm that ships empty boxes and books revenue is a fraud. A firm that ships actual product and books all of the revenue without any provision for bad debts has questionable accounting practices.
- Multiple groups can investigate the same company, but they *must* work *independently*!
- The degree of difficulty will be taken in account in grading your project. For example, if you investigate a firm with questionable pension accounting practices, which we will not cover in class until after the assignment is due, you will be given more slack in grading

than if you investigate a simple revenue recognition issue. Thus, you are *encouraged* to investigate accounting issues that are difficult and that we haven't covered, or won't cover, in class.

- Companies with problems that have occurred within the past 5 years will be given more credit than problems that occurred longer ago.
- You will need to find financial statements for the company. Search for the company on the SEC Edgar system (which can be accessed through the Lippincott Library page) or check out the company's web site to ensure you have access to financial statements.
- If you have any questions, please feel free to talk to me about your choice of company to investigate.

Once you have chosen a company, write a report on the company that addresses the following issues:

1. Describe the economic transaction(s) underlying the questionable accounting. Discuss the transaction in the context of the company's business and strategy (you may need to look in the company's annual report for this material).
2. Describe the accounting procedure used by the company and the accounting procedure that "should" have been used according to the critics of the accounting practice. Journal entries may be helpful here in laying out the accounting. What is the basis or justification for the company's accounting practices and for the alternative accounting practices in terms of accounting rules and concepts? How detailed or forthcoming about the accounting procedure was the company in its annual report prior to the controversy?
3. What indications were there (if any) of the problem that an astute analyst might have seen in advance?
4. Do you agree with the critics that the company's accounting practices were wrong, given your answers to the above questions? Why or why not? Note that, just because a company gets criticized for its accounting, it is not necessarily doing the wrong thing. Microsoft has been investigated by the SEC numerous times for questionable accounting practices and has been cleared every time. Are there changes to accounting or auditing standards you would recommend based on what happened?
5. If the company were to restate its financial statements using the accounting procedure that "should" have been used, what would be the effect on the a) income statement, b) balance sheet, and c) statement of cash flows? You do not have to replicate the entire statement; you just need to indicate changes (e.g., accounts receivable would increase, net income would decrease, etc.)
6. Why do you think the alleged problem occurred?
7. What were the consequences of the revelation/resolution of the problem? What happened to the firm's stock price? Did anyone get prosecuted or sent to jail? Were any fines levied? Etc.
8. Does the revelation of the company's alleged flawed accounting practices change your assessment of the company's long-run value? If so, how? If not, why not? Here I want

something more substantive than the statement “value is based on cash flow, not on accounting numbers.”

Hand in the following:

- A written report which addresses these issues. There is no page or word limit on your write up of this assignment, but please use 12 pt. font and at least a 1” margin on each side.
- The article, analyst report, or SEC enforcement bulletin that alerted you to the situation.
- The most recent set of financial statements issued by the company prior to the controversy.
- Any other exhibits or material to support your analysis.

Final Exam

The final exam will be a take-home exam. While it is “officially” cumulative, it will concentrate on material covered since the midterm exam.

The final exam is a take home that will be distributed on the last day of class – Wed April 22. It is due (in the accounting suite- 1300 SH-DH) on Monday April 27th at 3 pm.

More details on the exam will be provided as the time gets closer.

Sample questions and solutions will be available from Web Café.

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. Violations of these procedures will constitute cheating and could result in receiving an F for the course.

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 Jan 14	Introduction and The Post-Enron Financial Reporting Environment	Enron
2	Wed Jan 21	Accounting Earnings Quality	Corbomax
3	Mon Jan 26	Cash Flow Quality	SCF - Alpha and Beta SCF - Epsilon and Omega
4	Wed Jan 28	Alternative Measures of Profitability	Millennium Pharmaceuticals
5	Mon Feb 2	Earnings Per Share and Dilution	Ciber Inc
6	Wed Feb 4	Revenue Recognition – Gross versus Net and Multiple Deliverables	Merck; Yahoo vs Google –
7	Mon Feb 9	Revenue Recognition and Uncollectibles	Patten
8	Wed Feb 11	Securitization	H&R Block
9	Mon Feb 16	Fair Value Accounting – Gains and Losses	Morgan Stanley
10	Wed Feb 18	Derivatives	Global Candy Company –
11	Mon Feb 23	Risk Disclosures	Sun Microsystems
12	Wed Feb 25	MIDTERM EXAM	
13	Mon Mar 2	Stock Option Accounting	Google
14	Wed Mar 4	Valuing Stock Options	Valuing a Stock Option
	Mar 9 and Mar 11	NO CLASS – SPRING BREAK	
15	Mon Mar 16	Intangible Assets	Sun Microsystems
16	Wed Mar 18	Intangible Assets II	Nike
17	Mon Mar 23	Long Term Debt – Market vs Book Values	MGM
18	Wed Mar 25	Pensions and OPEB	American Airlines
19	Mon Mar 30	** GROUP PROJECT DUE **	
20	Wed Apr 1	Consolidations	Coca-Cola
21	Mon Apr 6	SPE's and Variable Interest Entities	Alza
22	Wed Apr 8	Multinationals and Foreign Currency Translation	Machinery International
23	Mon Apr 13	Segmental Reporting and EVA	Pepsi
24	Wed Apr 15	Income Taxes and Fin 48	TBA
25	Mon Apr 20	Risk Analysis and Prediction	Sun Microsystems
26	Wed Apr 22	Sarbanes Oxley and IFRS	None
27	Mon Apr 27	NO CLASS – FINAL EXAM DUE	

Preliminary Schedule of Assignments

RCJ: refers to Revsine, Collins, Johnson, *Financial Reporting and Analysis*, 4th ed.

Session	Date	Topic
1	Wed Jan 14	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?
2	Wed Jan 21	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	Mon Jan 26	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

4	Wed Jan 28	Alternative Definitions of Profitability
	Read:	<p>RCJ, Chapters 1 and 2 (Skim both)</p> <p>Class Notes on Alternative Definitions of Earnings</p> <p>A Clear Look at EBITDA</p> <p>The Evils of EBITDA</p> <p>EBITDA's Foggy Bottom Line</p> <p>Top 10 Limitations of EBITDA</p> <p>Out, by \$100 billion - How Pro Forma Accounting Boosts Profits</p> <p>New SEC Requirements For Pro Forma Statements and Annual Reports</p> <p>Lies, Damn Lies, and Pro Forma</p> <p>Non-GAAP Measures- Love Them or Hate Them?</p> <p>Pro Forma Numbers Are Alive and Well</p> <p>Stock Options, Meet Pro Forma</p> <p>“One Statement or Two?” Tabled by FASB</p> <p>Profit As We Know It Could be Lost With New Accounting Statements</p> <p>Financial Statement Presentation – Excerpts From Current Status of Joint FASB – IASB Project</p>
	Prepare:	Millennium Pharmaceuticals

5	Mon Feb 2	Earnings Per Share and Dilution
	Read:	<p>RCJ Chapter 15</p> <p>Class Notes – Dilution and Earnings Per Share</p> <p>Dilution of Employee Stock Options</p> <p>New EITF Pronouncement Aims to Close CoCo Loophole</p> <p>Ciber Declares it will Settle at least 30% of its Convertible Debt in Cash Helps Mitigate FASB Stance</p> <p>Ciber's Money Where Its Mouth Is</p> <p>Move Over CoCo's: Net Shares Will Do</p>
	Prepare:	Ciber, Inc – Stock Options, Convertible Debt, and Dilution

6	Wed Feb 4	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

7	Mon Feb 9	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	Wed Feb 11	Securitizations
	Read:	RCJ: Chapter 8: pp. 396-405 Class Notes on Transfers of Financial Assets Examples of Securitizations: Calculation of Gains and Losses American Securitization Forum: Testimony Before Congress Excerpts from Deloitte and Touche: Securitization Accounting Scandal: Subprime Meltdown; Securitization 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	Mon Feb 16	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</p> <p>Shining a Light on Companies Accounts</p> <p>Fair Value Measures</p> <p>Fair Value Accounting</p> <p>It’s Time to Get Real About Realizations</p> <p>“FASB’s New Draft on Values: Good News and ...”</p> <p>“Standards & Poor’s Comments on FASB’s Proposed Statement on Optional Fair Value Reporting”</p> <p>Show Business – A Blockbuster Deal Shows How Enron Overplayed Its Hand</p> <p>The Adventures of Enron, Blockbuster, and Me</p> <p>Enron’s Mark to Market Adventures</p> <p>Historical Cost Vs Fair Value of a Bond</p> <p>Astoria Financial (see spreadsheet on course web page)</p>
	Prepare:	Morgan Stanley

10	Wed Feb 18	Derivatives
	Read:	<p>RCJ: Chapter 11, pp 585604</p> <p>Class Notes On Hedging and Derivatives</p> <p>Derivative Wars</p> <p>Goldman Sachs’ Report on Porsche (skim)</p> <p>EDS Isn't Alone in Betting on a Rising Stock</p> <p>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

11	Mon Feb 23	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

12	Wed Feb 25	MIDTERM EXAM
	Read:	Open Book – Open Notes Covers material through Monday Feb 23.

13	Mon Mar 2	Stock Option Accounting
	Read:	<p>RCJ: Chapter 15, pp. 836-854</p> <p>Class Notes on Employee Stock Options , Dilution, and Notes on Earnings Per Share</p> <p>“Basic Principles in the New Accounting for Stock Options”</p> <p>“Accounting for Stock Options”</p> <p>“For the Last Time – Stock Options are an Expense”</p> <p>“Buffet vs Grove”</p> <p>“Cisco’s Bold Idea”</p> <p>“Focus in Apple’s Option Scandal Shifts to Board”</p>
	Prepare:	Google Inc

14	Wed Mar 4	Valuation of Employee Stock Options
	Read:	<p>"The Best Way of Valuing Options," Business Week, July 30, 2002</p> <p>“New Valuation Model could dampen the controversy over expensing employee stock options”</p> <p>"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.</p> <p>“Using the Black Scholes Model”</p> <p>“How To Excel at Option Valuation”</p> <p>“Cisco’s Stock Option Valuation 2006”</p> <p>“Google Creates Options Market”</p> <p>“Are TSO’s A New Trend?”</p>
	Prepare:	Valuing an Employee Stock Option (see spreadsheet on course web page)

15	Mon Mar 16	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)

16	Wed Mar 18	Intangible Assets
	Read:	“Measuring the Intangible Assets of a Firm” “The Top 100 Brands”
	Prepare:	Nike

17	Mon Mar 23	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

18	Wed Mar 25	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

19	Mon Mar 30	NO CLASS – GROUP PROJECTS DUE
	Read:	None
	Prepare:	None

20	Wed Apr 1	Intercorporate 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)

21	Mon Apr 6	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

22	Wed Apr 8	Multinationals and Currency Rate Fluctuations
	Read:	Class Notes on Foreign Currency As Exchange Rates Swing Carmakers Duck Natural Performers
	Prepare:	Machinery International

23	Mon Apr 13	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]

24	Wed Apr 15	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

25	Mon Apr 20	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]

26	Wed Apr 22	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

27	Mon Apr 27	NO CLASS - FINAL EXAM DUE