

ACCT 742
Problems in Financial Reporting
Spring 2008 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:

- Earnings and Cash Flow Quality
- Earnings per share and Alternative Measures of Performance
- Revenue Recognition
- Securitizations
- Fair Value and Mark to Market
- Derivatives
- Stock Options
- Pensions
- Consolidation of Debt vs “Off Balance Sheet” Debt
- Special Purpose Entities and Control
- The Financial Reporting Environment Post Enron
 - The Sarbanes-Oxley Law

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 spend time on financial statement analysis, ratios, and forecasting.

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, all of the material will be available on 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.

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 final exam. Inside the folder for a given class session, you will see three subfolders:

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

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. The slides will be printed out for you and distributed at the beginning of class.

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.

Grading and Course Requirements

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

Class participation	25 %
Individually Done Case Write Ups	30 %
Course Project (group)	45 %
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.

Each student is assigned one case based on the first letter of their last name:

<u>Students with Last Names beginning with</u>	<u>Assigned Case</u>
A-F	Statement of Cash Flows Classification
G-L	Ciber Inc
M-S	Google Inc
T-Z	American Airlines - Pensions

You are free to choose the other two cases you wish to write up OTHER THAN Sun Microsystems (the one on derivatives), and Enron.

I recommend you spread your case choices across the weekends during which we'll be meeting.

Course Project:

Students are asked to form groups of up to 4. Groups should be finalized and your company choice made by the second group of class meetings (March 21). The earlier you decide on a company, the more time you'll have to work on it.

Each group is expected to turn in the Course project on the last day of class. In addition to submitting a written assignment for the project, group members will be expected to prepare a brief presentation of their findings. We will do the presentations during the last class.

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. Be sure that the issue your group tackles has a significant element of accounting judgment. Putting the wrong date on a sales contract or an option grant (i.e., backdating) is simply fraud, not an accounting judgment issue.

Please do not choose Enron, Sunbeam, Worldcom, Microstrategy, 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 one of the cases 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. If I feel the firm/controversy is inappropriate, I will veto it.

There is a folder on Web Café with more information about how cases will be graded, along with some examples of cases from past years.

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

ACCOUNTING 742

Group Project Assignment

The Wharton School
Due April 5, 2008

Please prepare a written report for the following group assignment before class on April 5, 2007. During class on that day, you will be expected to do a *brief* presentation of your findings (approximately 10 minutes – I'll adjust the time based on the number of groups there turns out to be).

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

There is no Final Exam in this 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 Overview

Note that I have broken up our meetings into 1.5-hour long sessions. For example, Sessions 1 and 2 are part of a three hour long session on March 7.

<u>Session</u>	<u>Date</u>	<u>Topic</u>	<u>Problem/Case</u>
1	Fri Mar 7 9:30-11:00	Introduction and Cash Flow Statement	Cash Flow Classification: Alpha vs Beta AND Epsilon vs Omega (Students with last names A- F turn in BOTH these cases)
2	Fri Mar 7 11:00-12:30	Earnings Per Share and Alternative Measures of Performance	Ciber Inc (students with last names G-L turn in this case)
3	Sat Mar 8 1:00-2:30	Revenue Recognition	Patten Corp (see also spreadsheet on web café)
4	Sat Mar 8 2:30-4:00	Securitizations and the Subprime Lending Crisis	H&R Block
5	Thurs Mar 20 4:45 – 6:45	Stock Options	Google (Students with last names M-S turn in this case)
6	Fri Mar 21 9:00-10:30	Derivatives	Sun Microsystems (not allowable to be turned in)
7	Fri Mar 21 10:30-12:00	Fair Values	Morgan Stanley
8	Fri Apr 4 1:30-3:00	Pensions and Other Post Employment Benefits (OPEB)	American Airlines (Students with last names T-Z turn in this case)
9	Fri Apr 4 3:00-4:30	Off balance sheet financing, SPE's, and VIE's	Alza
10	Sat Apr 5 9:00-10:30	Financial Reporting Post Enron and the Sarbanes Oxley Law	Enron (not allowable to be turned in)
11	Sat Apr 5 10:30-12:00	PROJECT PRESENTATIONS	

(*) Sun, and Enron -- These cases are not in the set that can be turned in.

Preliminary Schedule of Assignments

RCJ: refers to Revsine, Collins, Johnson, *Financial Reporting and Analysis*, 2nd ed.

Session	Date	Topic
1	Fri Mar 7 9:30-11:00	Cash Flow Statement
	Read:	<p>RCJ: Chapter 17 RCJ: Chapter 4, pp. 174-185 RCJ: Chapter 6, page 301</p> <p>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</p> <p>A Clear Look at EBITDA The Evils of EBITDA EBITDA’s Foggy Bottom Line Top 10 Limitations of EBITDA</p> <p>Testimony of Richard Roach on Enron Prepays (SKIM ONLY)</p>
	Prepare:	<p>BOTH CASES on Statement of Cash Flow Classification Case 1: ALPHA and BETA Case 2: EPSILON and OMEGA</p> <p>Both cases must be turned in to count as one of your 3 case writeups STUDENTS with last names ending in A-F must turn in both these cases; Other students may also turn in these cases, but they must turn in BOTH for it to count</p>

2	Fri Mar 7 11:00-12:30	Earnings Per Share and Alternative Measures of Performance
	Read:	<p>RCJ Chapter 15 Class Notes – Dilution and Earnings Per Share 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> <p>SKIM THE FOLLOWING 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>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:	Ciber, Inc (Students with Last Names ending in G-L turn in this case)
3	Sat Mar 8 1:00-2:30	Revenue Recognition
	Read:	<p>RCJ Chapter 2, pp. 45-51 RCJ Chapter 3 (especially pp. 117—125) RCJ Chapter 8, pp. 383-395</p> <p>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</p> <p>Revenue Recognition Remains Accounting’s 800-lb Gorilla Gross versus Net Presentation of Revenue Yahoo, Google, and Internet Math Xerox Settles SEC Enforcement Action Charging Company with Fraud</p>

4	Sat Mar 8 2:30-4:00	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

5	Thu Mar 20 4:45-6:45	Stock Options
	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” "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:	Google

6	Sat Apr 7 9:00-10:30	Derivatives
	Read:	RCJ: Chapter 11, pp 585-604 Class Notes On Hedging and Derivatives Derivative Wars Goldman Sachs' Report on Porsche (SKIM ONLY) 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 Global Candy Company – Problem and Solution “Value at Risk” Lost in the Maze This Much Is Clear: FAS 133 Needs To Go
	Prepare:	Sun Microsystems (not allowable to be turned in)

7	Fri Mar 21 10:30-12:00	Fair Value and Mark-to-Market
	Read:	RCJ: Chapter 11, pp. 563-579; Chapter 16, pp. 885-891 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 “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 Historical Cost Vs Fair Value of a Bond
	Prepare:	Morgan Stanley (note: this case is not in the syllabus. It is only available via web café).

8	Fri Apr 4 1:30-3:00	Pensions and Other Post Employment Benefits
	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

9	Fri Apr 4 3:00-4:30	SPE's and Joint Ventures
	Read:	"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," "From SPE's to VIE's"
	Prepare:	Alza

10	Sat Apr 5 10:30-12:00	The Financial Reporting Environment Post Enron
	Read:	<p>“The Rise and Fall of Enron”</p> <p>“Timeline of the major Enron-related events”</p> <p>“Timeline of key events leading to Andersen demise”</p> <p>“An Enron Primer”</p> <p>Two Years Later – A Recap of The Sarbanes-Oxley Act of 2002 And Related SEC Rulemaking</p> <p>Japan Regulators To Require U.S.-Style Reporting Standards</p> <p>SOX 404 – Unintended Consequences and its Impact on Small Business (SKIM ONLY)</p> <p>Sarbanes-Oxley has been a pretty clean sweep ; Most agree it's a big success</p> <p>Sarbox Isn't Really Driving Stocks Away</p> <p>Politics & Economics: Sarbanes-Oxley Audit Rules Likely to Ease</p> <p>IFRS: Coming to America</p> <p>The Top 10 Reasons to Fix the FASB's Conceptual Framework</p>
	Prepare:	<p>Enron What went wrong at Enron? Discuss the roles of management, the board of directors, the auditor, the financial accounting rule making process, analysts, investment banking firms, and Congress.</p> <p>What features of the Sarbanes Oxley Act do you think will be most effective?</p>
11	Sat Apr 5 10:30-12:00	Group Presentations