



**DIVISION OF ECONOMIC AND FINANCIAL STUDIES
DEPARTMENT OF ACCOUNTING AND FINANCE**

ACCG350
FINANCIAL STATEMENT ANALYSIS
Semester One
2004

UNIT OUTLINE

Student Resource Centre
Division of Economic & Financial Studies
MACQUARIE UNIVERSITY

TEACHING STAFF

Lecturer-in-Charge

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Lecturers

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UNIT DESCRIPTION

In this unit, you will learn about the five stages of analysing a business from its financial reports: business and strategic analysis, accounting analysis, financial analysis, forecasting and valuation. These stages will be applied to a class case study of a current Australian company, using its annual report. Throughout the semester, you will work in small groups on a major assignment analysing the financial statements of (another) Australian company.

UNIT OBJECTIVES

This unit will provide you with an understanding of the theories and practice of financial statement analysis, which will enable you to thoroughly analyse and to prepare a report on a firm's financial position and estimate its fundamental value from its annual report. You will develop analytical skills in information management, analysis and interpretation in a multi-disciplinary environment.

PREQUISITE

ACCG253 Financial Management

The content of this unit draws on both ACCG101 Accounting 1B (particularly cash flow statements) and ACCG253 Financial Management.

TEACHING FORMAT

You are expected to attend the weekly lecture, either Thursday 1-3pm in C5CT2, or Thursday 6-8pm in E7BT5 and a one-hour weekly tutorial. Copies of the lecture transparencies will be generally available from the website in the week prior to the lecture.

WEBSITE

The website for this unit can be accessed via

www.accg.mq.edu.au/undergrad/units.html under the entry for ACCG350 Financial Statement Analysis. It contains all information provided in this unit outline, as well as copies of lecture transparencies and announcements and changes made during the semester. Please consult it regularly.

TEXTBOOKS

1. Lundholm and Sloane, Equity Valuation and Analysis, Irwin McGraw-Hill, 2004.
2. Case Studies for ACCG350 Financial Statement Analysis
3. ACCG350 Readings Book

Palepu, Healy and Bernard, Business Analysis and Valuation, Thomson, 2004 is recommended as a supplementary text. Copies are available in the library.

ASSESSMENT AND GRADING

Tutorial Attendance and Participation	10%
Case Study Preparation	10%
Major Assignment	20%
Final Examination	60%

In order to pass this unit, you must pass the final examination and the unit overall.

PRIZE

The Macquarie University Accounting and Finance Prize for ACCG350, worth \$100, will be awarded to the student with the best performance in this unit.

TUTORIALS

Tutorial attendance is essential to master the material in this unit. Attendance will be recorded weekly, and tutorial assessment of up to 10% will be based on your attendance and contribution. Tutorial solutions for each topic will be placed in ERIC in the following week.

CASE STUDIES

Five case studies will be investigated and discussed in tutorials throughout the semester. You are required to prepare these case studies prior to the relevant weekly tutorial, and to submit answers to a one page question sheet for each case study on the Monday of the relevant week, i.e. prior to the tutorial. The question sheets will be available on the webpage at the beginning of the semester. Your answers to these questions will be graded satisfactory (2 marks) or unsatisfactory (0 marks). Total contribution of case studies towards your final grade is 10% (5 x 2%). Note that one third of the final examination (20% of the final mark) will be based on selected case studies.

FINAL EXAMINATION

There will be a three hour final examination, consisting of three parts: questions on the major project, questions on the case studies, and questions on other topics. Non-programmable calculators will be allowed in the examination. You will not be allowed to use translation dictionaries in the final examination for this unit. You must attend this examination, unless clearly prevented from doing so by illness or misadventure.

MAJOR ASSIGNMENT

In groups of two or three students, evaluate and report on the most recent annual report of an Australian company (chosen from the list below), as if you were security analysts making a recommendation on whether or not your clients should invest in it.

The report is due on 7th June. It is to be approximately 15 – 20 pages in length and to include the following sections:

1. **Business and Strategic Analysis**, including an analysis of the economy, the industry, and the company's place in the industry; the company's competitive and corporate strategy; the company's and the industry's growth potential; and the implications of all of these for its future profitability.
2. **Accounting Analysis**, including an analysis of the company's accounting policies that are likely to affect the interpretation of its financial reports, and a comparison to those of a competitor in the same industry;
3. **Financial Analysis**, including the presentation and interpretation of relevant ratios for the company and a competitor, a time series analysis of these for both companies over the past three years, and an analysis of the company's overall financial position.
4. **Prospective Analysis**, including forecasts for all three financial statements in full for the company for one financial year, with reasons for major items, and valuation of the company using two different methods;
5. **Recommendation** for your clients, drawing on the whole analysis of the company.

A cover sheet is attached to this outline. Your report should be word-processed and professionally presented, and secured with plastic spiral binding. All assumptions should be clearly stated and supported if possible. Please consult with the lecturer-in-charge if further clarification is needed.

Assessment and marking of this assignment will be

- 5% for a short presentation on section 1 of your assignment in your tutorial in week 4 (all groups members to speak)
- 5% for a short presentation on sections 2 and 3 of your assignment in your tutorial in week 7 (all group members to speak)
- 20% for questions in the final examination based on your major assignment (including for example, reasons why certain methods or data have been chosen, assumptions behind calculations)
- 10% for the final report, to be submitted in week 13, on the basis of its accuracy, comprehensiveness, cohesiveness, and overall quality.

LIST OF AUSTRALIAN COMPANIES TO USE FOR MAJOR ASSIGNMENT

Angus and Coote	(www.anguscoote.com.au)
Bridgestone Australia	(www.bridgestone.com.au)
Commsecure	(www.commsecure.com.au)
Foodland	(www.fal.com.au)
Hills Motorway	(www.hillsmotorway.com.au)
Hutchison	(www.hutchison.com.au)
Orica	(www.orica.com.au)
Prime Television	(www.primetv.com.au)

STUDENT INFORMATION

Please refer to these websites for information on the following topics:

Plagiarism: www.student.mq.edu.au/plagiarism

Requests for special consideration and the granting of supplementary exams:

<http://handbook.mq.edu.au/PDF/ug-bachelor-degree-rules.pdf> (See also Bachelor Degree Rules 8, 9 and 10 on page 88 of the 2004 Macquarie Handbook)

GRADING SYSTEM

Please refer to the attached table for information regarding the grading system. Note that your "sng" will not be the same as the total of the marks that you achieve for the four assessment components in this unit. It will reflect your relative ranking within the grade you achieve, and is intended to provide additional information on your overall performance in the unit.

<u>Grade</u>	<u>SNG</u>	<u>Description</u>
HD High Distinction	85-100	Denotes performance which meets all unit objectives in such an exceptional way and with such marked excellence that it deserves the highest level of recognition
D Distinction	75-84	Denotes performance which clearly deserves a very high level of recognition as an excellent achievement in the unit
CR Credit	65-74	Denotes performance which is substantially better than would normally be expected of competent students in the unit
P Pass	50-64	Denotes performance which satisfies unit objectives
PC Conceded Pass	45-49	Denotes performance which meets unit objectives only marginally
F Fail	0-44	Denotes that a candidate has failed to complete a unit satisfactorily
FA Fail Absent	0-44	Denotes that a candidate has failed to complete a unit satisfactorily and was absent from a compulsory final examination

TUTORIAL QUESTIONS

WEEK 2

From Palepu, Healy and Bernard, Business Analysis and Valuation, Third Edition, Thompson, 2004

1. Coca-Cola and Pepsi are both very profitable soft drinks. Inputs for these products include sugar, bottles/cans, and soft drink syrup. Coca-Cola and Pepsi produce the syrup themselves and purchase the other inputs. They then enter into exclusive contracts with independent bottlers to produce their products. Use the five forces framework and your knowledge of the soft drink industry to explain how Coca-Cola and Pepsi are able to retain most of the profits in this industry.
2. In the early 1980's, United, Delta and American Airlines each started frequent flier programs as a way to differentiate themselves in response to excess capacity in the industry. Many industry analysts, however, believe that this move had only mixed success. Use the competitive advantage concepts to explain why.
3. There are very few companies that are able to be both cost leaders and differentiators. Why? Can you think of a company that has been successful at both?

WEEK 3

1. The roles of ASIC and ASX in accounting standard setting in Australia may change as a result of the adoption of International Financial Reporting Standards in 2005. Discuss the ways in which the roles of these two bodies may change.
2. Consider the recent corporate collapses in Australia. What do these events reveal about the effectiveness (or otherwise) of the Continuous Disclosure regime?
3. "It is more appropriate to rely on consolidated, rather than parent entity figures for financial statement analysis and corporate valuation". Discuss
4. In agency relationships, are agents or principals more likely to bear agency costs? Explain your answer.
5. Pleasure Pty Ltd is a small company that is about to float on ASX. It operates solely in the leisure industry, managing a chain of gambling casinos in NSW and Victoria. Pleasure Pty Ltd disclosed in the float prospectus that it has experienced significant positive growth in the last two years, and that it anticipates this will continue indefinitely after the float. However, the amount of capital raised via the initial public offering (IPO) will be within the bottom quartile of Australian floats during the past twelve months.

Imagine you are a potential investor in the IPO. Do you anticipate that the forecasts of earnings in the prospectus are more likely to be managed upward or downwards? Explain your answer.

WEEK 11

From Palepu, Healy and Bernard, Business Analysis and Valuation, Third Edition, Thompson, 2004

1. Give an example of an Australian company in each of the following categories, and describe the market's view of that company's future prospects:

- (a) a high PE and a low market-to-book ratio
- (b) a high PE and a high market-to-book ratio
- (c) a low PE and a low market-to-book ratio
- (d) a low PE and a high market-to-book ratio

2. The Boston Tea Company plans to acquire Hi Flavor Soda Co. for \$60 per share, a 50 per cent premium over current market price. John E. Gray, the CFO of Boston Tea, argues that this valuation can easily be justified, using a price-earnings analysis. "Boston Tea has a price-earnings ratio of 15, and we expect that we will be able to generate long-term earnings for Hi Flavor Soda of \$5 per share. This implies that Hi Flavor is worth \$75 to us, well below our \$60 offer price". Do you agree with this analysis? What are Grey's key assumptions?

From Stickney and Brown, Financial Reporting and Statement Analysis, Dryden, Fourth Edition, 1999

3. Selected data for Wal-Mart Stores for Year 7 appear in Table 11.2.

- (a) Compute the theoretical and actual PE ratios for Wal-Mart at the end of Year 7. Assume that the risk-free interest rate is 6 per cent and that the market equity premium over the risk-free interest rate is 7 percentage points.
- (b) Compute the growth rate in earnings implied by the actual PE ratio, assuming that the cost of equity capital is correct.
- (c) Compute the cost of equity capital implied by the actual PE ratio, assuming that the historical growth rate in earnings is correct and sustainable.
- (d) Compute the theoretical and actual P-BV ratios at the end of Year 7. Assume that Wal-Mart will maintain a dividend payout rate of 21 percent, and that the rate of return on shareholders' equity will be as follows:

Year 8: 20.5%
Year 9: 19.7%
Year 10: 18.9%

Year 11: 18.3%
 Year 12: 17.3%
 Year 13: 16.3%
 Year 14: 15.3%
 Year 15: 14.3%
 Year 16: 13.3%
 Year 17: 12.3%

The rate of return on shareholders' equity will equal the cost of equity capital after Year 17.

(e) Given your analyses above, discuss whether you think that Wal-Mart is undervalued, overvalued or fairly valued by the market.

Net Income for Year 7 (in millions)	\$3 056
Earnings Per Share for Year 7	\$1.33
Dividends/Net Income for Year 7	21%
Historical Annual Growth Rate in Earnings	6.6%
Shareholders' Equity at Beginning of Year 7 (in millions)	\$14 756
Shareholders' Equity at End of Year 7 (in millions)	\$17 143
Market Equity Beta	0.83
Market Price per Share at End of Year 7	\$23.50
Number of Shares Outstanding at End of Year 7 (in millions)	2, 298

WEEK 12

1. What is 'indexing'? How does it differ from 'active' investing?
2. What are the advantages and disadvantages of indexing?
3. Indexing is more developed in the US than Australia, and more popular with institutional than individual investors. Why might this be the case?
4. What is ethical investing?
5. Imagine that you are the investment analyst for an ethical investment fund. What issues might you face that are different from a traditional financial analyst?
6. Why might ethical investments financially outperform 'traditional' investments? Why might they underperform?
7. Why do Haigh and Hazelton (2004) criticize ethical investment? Why do they believe ethical fund managers should lobby governments?

LECTURE AND TUTORIAL SCHEDULE

<u>WEEK</u>	<u>DATE</u>	<u>TOPIC</u>	<u>TEXTBOOK READING</u>	<u>ARTICLES READING</u>	<u>TUTORIAL ASSIGNMENT</u>
1	1/3	Introduction Strategic and Industry Analysis	Chapter 1, 2, 3	Brown (1970)	No tutorials in first week
2	8/3	Accounting Issues	Chapter 4 (4.1 – 4.3)	Whitted, Zimmer, Taylor and Wells, pp 3-6, 34-45	Tutorial questions week 2
3	15/3	Accounting Analysis	Chapter 4 (4.4 – 4.6)		Tutorial questions week 3
4	22/3	Interpreting Accounting Ratios	Chapter 5		<i>First presentation of major assignment</i>
5	29/3	Interpreting Accounting Ratios cont. Analysing the Cash Flow Statement	Chapter 6		"Bigger Isn't Always Better"
6	5/4	Cross-Sectional and Time-Series Analyses	Foster Chapters 6, 7	Beattie and Jones (1999) Roberts (1999) ARA Criteria Booklet	"Playing the Numbers Game"
MID-SEMESTER BREAK					
7	26/4	Forecasting	Chapters 7, 8		<i>Second presentation of major assignment</i>
8	3/5	Valuation using Dividends and Cash Flows	Chapters 6, 10		"The Body Shop International"
9	10/5	Valuation using Earnings Valuation using Balance Sheets	Chapter 10		"How Low Can It Go?"
10	17/5	Valuation in Practice			"Rocky Mountain Advanced Genome"
11	24/5	Interpreting Market Ratios	Chapter 11	Penman (1996)	To be advised
12	31/5	Index and Ethical Investing		Haigh & Hazelton (2004) Hancock (1999) Hely (2000) Power (2002) Vanguard (2001)	Tutorial questions week 11
13	7/6	Other Issues Revision <i>Major Assignment Due</i>	Chapter 12		Tutorial questions week 12