

TEACHING FINANCIAL STATEMENT ANALYSIS

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This paper discusses teaching methods in a financial statement analysis course. It focuses on the oral presentation and written analytical report requirements.

INTRODUCTION

At Sacred Heart University, College of Business, the course of Financial Statement Analysis is offered by the Economics & Finance Department. It is a one-semester course. All Accounting majors are required to take this course. It is an elective course for Finance and Business majors. This course has a reputation of being among the most rigorous courses in the College of Business curriculum.

COURSE REQUIREMENTS

Prerequisite for this course is either: basic course in Financial Management, or the second course in Intermediate Accounting.

All students must complete all of the following items.

- ☞ 2 oral presentations in front of the entire class
- ☞ In class mid-semester examination
- ☞ In class final examination
- ☞ Semester long written analytical report

At the beginning of the course, each student is assigned a different publicly-held corporation to be analyzed. We try to assign based on students' interests and responses to a questionnaire taken on the very first day of class. Assigned corporations are limited to manufacturing and retail industries. Other specialized industries (e.g., financial institutions, utilities, transportation, etc.) have their own unique analytical needs that are beyond the scope of this course. Immediately, students must obtain financial statements for the 4 most recent years. Complete annual reports, including footnotes, are required for the most recent year. The oral and written reports focus on this corporation.

ORAL PRESENTATIONS

The first oral presentation is required 2 weeks into the semester. Students research their assigned corporations and report on the following questions.

Question 1: Briefly discuss your assigned corporation and its industry. What are its markets of strength? Future direction? Give a recent sales breakdown of your firm's products. Discuss any interesting anecdotes of your corporation. Assume your audience knows absolutely nothing about your corporation.

Question 2: Examine the Independent Auditor's opinion for the most recent year. Identify the Auditor? Comment on the opinion. How would this opinion influence your analysis of the financial statements?

Question 3: For the most recent year, what inventory method does your firm use? Is the method consistent with the nature of your corporation's business? Does the inventory method make the reported numbers more conservative or less conservative?

The oral presentation should last about 5 minutes. After the presentation, the audience is invited to ask questions. There is a limit of 2-3 audience questions. Then, I ask a minimum of 2 questions – either for clarification purposes, or seeking more detail. The students experience much poise during this first oral presentation!

The second oral presentation is given during the last week of classes. They answer this question: would you buy or sell your assigned corporation’s common stock? In 10 minutes, students must fully justify their decisions. Similar to the first oral presentation, the audience is invited to ask about 2-3 questions and I ask a minimum of 2 questions.

Their justifications are dependent on the research obtained from the written analytical report. We now discuss this report.

WRITTEN ANALYTICAL REPORT

This report requires the entire semester to complete. It is due on the last day of class. There are 2 parts.

Part I – Basic Analytical Techniques

Questions 1,2,3: These are the same questions discussed on the previous pages. They start off the written report.

Question 4: Summary of the Sarbanes-Oxley Act of 2002. Because of the importance of this new Act on financial statements, students are requested to have some knowledge of this Act. The summary should be only 1-2 pages long. All sources of information must be identified.

Question 5: Balance sheet vertical common size. The corporation’s balance sheet accounts must be summarized and reported in the following format.

	2003	2002	2001	2000
Cash, cash equiv, market.sec.				
Accounts receivable				
Inventories				
Other current assets				
Total current assets				
Net property, plant, equipment				
Other long term assets				
TOTAL ASSETS	100.0%	100.0%	100.0%	100.0%
Total current liabilities				
Long term debt				
Other long term liabilities				
Preferred stock				
Total common equity				
TOTAL LIAB. & EQUITY	100.0%	100.0%	100.0%	100.0%

Trends for each of the accounts above must be identified for the 4 year period. Also, discussion of possible causes for the trends is required.

Question 6: Income statement vertical common size. The corporation's income statement items must be summarized in the following format.

	2003	2002	2001	2000
Net sales	100.0%	100.0%	100.0%	100.0%
Less: Cost of sales				
Other expenses				
Interest expense				
= Earnings before taxes				
Less: Income taxes				
+/- Extraordinary items / adjust.				
= NET INCOME				

Trends for each account must be identified during the 4 year period. Comments on possible causes for the trends are requested.

Question 7: Ratio analysis. The following ratios must be performed each of the 4 year period. Be sure that the units (e.g.: times, days, percents, etc.) are specified.

Liquidity & solvency ratios: current ratio; quick ratio; average collection period; and times interest earned.

Profitability ratios: return on common equity (ROE); ROE broken down by the Dupont formula → profitability, turnover, and leverage.

Again, trend analysis and appropriate commentaries are required.

Question 8: Competitors analysis. Select two (2) major competitors of the assigned corporation. For the most recent year only (e.g. 2003), analyze your corporation vs. the 2 competitors in terms of each of the ratios found in Question 7.

Part II – Additional Analysis

Question 1: Revolving line of credit. Determine the revolving line of credit. Do you believe this amount is adequate for your firm?

Question 2: How does your firm recognize a sale? Comment

Question 3: Calculate your firm's "operating cycle" for the 3 most recent years. Be sure to break down by accounts receivable and inventory turnovers. Identify and discuss trends. [NOTE: Students are required to obtain 4 years of data. Because operating cycle calculations use "average" amounts; 4 years of data can only produce 3 years of calculations.]

Question 4: Examine the Statement of Cash Flows for the most recent year. Is the cash flow healthy or not? Discuss.

Question 5: Analyze the financial health of your firm's defined benefit pension plan. Is the plan adequately funded? Are the assumptions reasonable? Any other comments? [NOTE: If the firm does not have a defined benefit plan; the student will be assigned a defined benefit plan from another firm to answer this question.]

Question 6: For the most recent year, calculate and compare "actual return to stockholders" vs. "return on common equity." Comment.

Question 7: Calculate the Altman Z-score for the most recent year. Interpret the results.

Question 8: Identify the most recent Moody's bond rating. Do you believe it is justified?

Question 9: Based on the results of Part I and Part II, would you recommend purchase of your corporation's common stock? Full justify! [NOTE: This question is presented in the second oral report.]

EXAMINATIONS

The mid-semester examination and the final examination are scheduled at the appropriate times during the semester. Both examinations are open notebook, open textbook, and calculator permitted. The emphasis is on analytical and critical thinking, not rote memorization. Students are given problems and essays to complete. Successful completion requires the ability to apply the concepts to the questions.

CONCLUSION

With a heavy load of 2 oral presentations, a thorough analytical report, and 2 challenging examinations, it is no wonder that the Financial Statement Analysis course is indeed very rigorous. Nevertheless, despite the work load and the challenges, students do appreciate this course. Students have gained much useful knowledge about corporate financial statements.