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BADM 322.80: Business Finance - Honors

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UNIVERSITY OF MONTANA
SCHOOL OF BUSINESS ADMINISTRATION
ACCOUNTING AND FINANCE DEPARTMENT
BADM 322 (Honors)

Semester: FALL 2003
Time: M 1:10 PM - 4:00 PM

Instructor: Joseph D. Vinso

Office: GBB 370
Office Hours - Tuesday 2:00 PM - 4:00 PM
Phone: (406) 243-4309
email: joe.vinso@business.umt.edu (By far the easiest way to reach me)

Course Objectives:

This course is probably your first in finance, and it is the foundation for subsequent courses in corporate finance, security analysis, investments, capital markets, derivatives, international finance, international financial management, and real estate. It provides an overview of the modern theory and practice of financial management, and it develops a framework to analyze two fundamental financial decisions: *investment* and *financing*. My goals for this course include the following:

1. There are a certain set of skills that you have to learn to do anything in finance. These include how to compute present and future values; how to use present and future values in capital budgeting and security valuation; how to make investment decisions; how to decide the best financing alternatives for the firm; and how to manage the firm's working capital. In a one semester course many of these skills will not be fully developed, but you will at least be exposed to the basic concepts.
2. There is a vocabulary that you must learn. You need to know what a share of stock is, what a bond is, and the like.
3. There is *theory* to learn. You need to see how the theory of finance gets applied to decision making. Theory is a set of tools that you can use to organize your approach to any finance problem. You need to have that theory to know which tool in your tool-box of finance skills is the right one to use in any given situation.
4. You need to become an intelligent consumer of the financial press. You need to be able to understand the implications of what goes on in the financial world for you and your business.
5. It is important to know not only what or why things are done but also how. In that regard, we will be using EXCEL extensively for problem solving.

To that end, we will cover a number of different topics. In general, the first part of the course will be devoted to developing a set of skills, and the second part to applying those skills to various problems.

1. We begin with a look at the elements of financial statements and how they are used to perform financial analysis.
2. Next we look at discounted cash flow analysis, and apply the basic theory to the valuation of bonds, stocks, and individual capital budgeting projects. We also study the pricing of assets under uncertainty, including the tradeoff between risk and return, portfolio diversification and the Capital Asset Pricing Model.
3. Then we address the elements of financing decisions that includes financing sources, access to capital markets, debt and dividend policy. Alternative financial instruments, like options, may be introduced if time permits.
4. The course concludes with a discussion of working capital management.

The course emphasizes the fundamental concepts underlying modern finance and it is analytical and rigorous. While it is not "Rocket Science," students have found this to be a demanding, and sometimes difficult, course. While I will try to make things as accessible as possible, you must be aware that this material is not always easy, which is the nature of the beast, and mastering it will require time and effort.

Prerequisites:

Introductory Accounting and Algebra are required. Basic statistical and accounting constructs are developed as needed. It would be helpful to have had BADM 270 but not required.

Required Materials

First Text: Brealey and Myers, Principles of Corporate Finance, McGraw-Hill, 7th Edition, 2003

Second Text: Simon Benninga, Principles of Finance With Excel. This text is still in development. Copies of the various chapters are posted on Blackboard. These chapters are available only to those in the course and are not to be duplicated or disseminated to non-course members.

Software and Websites:

1. It will be necessary to be familiar with **EXCEL**. If you do not know how to use EXCEL, learn it quickly using the Chapters specified in the Benninga book. It will help you not only in this course but also in most of the other courses you will be taking at the business school.

2. A **Student CD-ROM** is Free with the book. It includes an outline of the text, certain EXCEL spreadsheets, general financial information, tutorials, interactive quizzes, copies of the PowerPoint slides, and various other items. It also includes access to various websites including McGraw-Hill's help center. It will be a valuable resource for you during this course.

3. **Standard & Poor's Educational Version of Market Insight.** McGraw-Hill/Irwin has partnered with Standard & Poor's to offer access to the Educational Version of Standard & Poor's Market Insight©. This rich online resource provides six years of financial data for 350 top companies. The password protected Website is one way to bring real data into your work. Access to this site is free with every new copy of the textbook. Visit the website: <http://www.mhhe.com/edumarketinsight>.

4. **PowerWeb** for Corporate Finance. This online resource provides high quality, peer-reviewed content including up-to-date articles from leading periodicals and journals, current news, weekly updates with assessment, Interactive exercises, Web research guide, study tips, and much more. Visit the website at: <http://www.dushkin.com/powerweb>.

5. **Business Week Edition.** You can subscribe to Business Week for a specially priced rate of \$8.25 additional. You should receive a pass code card shrink-wrapped with the text. The card directs you to a Website where you can enter the code and gain access to Business Week's registration page to enter address info and set up a print and online subscription as well.

6. **Wall Street Journal Edition.** You can subscribe to the Wall Street Journal for a specially priced rate of \$20.00 additional. You should receive a "How To Use the WSJ" handbook plus a pass code card shrink-wrapped with the text. These items direct you to a Website where you enter a code and gain access to the WSJ registration page to enter address info and set up your print and online subscription, and also to set up a subscription to Dow Jones Interactive online for a span of the 15-week period.

7. **Textbook Website.** McGraw-Hill maintains a website for this book at the following address: <http://www.mhhe.com/bm7e>. Just click on the information you are seeking and you get to a website that has a wealth of information linked to each chapter in the text. For each chapter there is an outline of the chapter, a set of computer based flashcards, the end of chapter materials, some quiz questions, and spreadsheets that you can use for some of the end-of-chapter problems.

Calculator:

You will need a calculator for all the exams and to work many of the problems. Any calculator which has an x^y button will work. You will, however, find that a financial calculator (such as an **HP10B2** or **TI BA II Plus**, or their successor) will be helpful on the exams, but only if you know how to use it. The best for the money and my personal preference is the Hewlett Packard **HP 12C**. The Bookstore has the **HP 10B2** and the **TI BA II+**. They do not offer any discounts and the price for the HP is much higher than available on the internet or other stores. The **TI BA II+** is competitive with that available on the internet. The **HP 12C** is not available in the bookstore but is

available on the internet and other stores such as Staples. Ranking them in the order of preference is **HP 12C** first, **TI BA II+** second, and last and a poor third the **HP 10B2**. *Note that laptops will not be allowed in the exams under any circumstances.* If you have a **calculator with memory** you must show that the memory has been completely cleared before you can use the calculator in the exams. If you cannot show this, you may not use that calculator. Frankly, if you can afford it, I advise getting a financial calculator to use rather than the graphical calculators you may have used in calculus.

Expectations:

This course has a reputation of being among the more difficult of the required BADM courses. That is probably true. The difficulty is a result of the nature of the material. I will try to make it as easy as possible for you to master the material; however, you must be prepared to work, and work hard, to do well in the course. This means that:

1. You are expected to have completed the assigned reading prior to class. I cannot stress this enough. If you do not get the readings done prior to class, you will not get everything you can out of the lectures, as in preparing the lectures I will assume that the reading has been done and will only cover what I think are the more difficult issues. Note that this is not "easy" reading. You may have to read the chapter(s) a few times to get it, so give yourself plenty of time. After each lecture go over the chapter(s) again. You should find that some points that were confusing have been clarified. Remember, read the chapter(s) before class, go to class, than read the chapter(s) again.
2. You should also keep yourself informed of the current events regarding financial matters. These regularly appear in the financial press such as the Wall Street Journal. I plan to work these current events in the financial world into the lecture to the extent possible.
3. You should make use of all of the support that is available. You should use the web-sites and the self-study CD. However, no amount of support materials will help if you are not making an honest effort on your own.
4. I plan to provide all materials except the syllabus and exams only in electronic form; all handouts, notices, supplementary notes etc., will be posted in **Blackboard** (see more on this below). Any class announcements and other notification will be posted in **Blackboard**. You should check this frequently.
5. If you miss a class session, it is your responsibility to acquire class notes and any handouts or other material from your classmates. Form a "buddy system." Any material distributed in class will be posted in **Blackboard**. The buddy system will also be useful in preparing for exams and working on Excel spreadsheets.
6. Form a study group. You will find that you learn more if you study in a group.
7. You are expected to come to lectures prepared. If you have not studied the assigned chapter(s)

and have not attempted to do the end-of-chapter problems, you are unlikely to benefit from the lectures. Do all the end of chapter problems. The only way to learn how to do the calculations is to do them--a lot of them. To help you, I will post the answers to all of the Brealey and Myers' end of chapter questions after we finish each chapter.

Grading:

Grading will be based on the following:

ACTIVITY	PERCENTAGE
Midterm 1	20%
Midterm 2	20%
Project Submission 1	10%
Project Submission 2	10%
Final Project Submission	10%
Final Exam	30%
TOTAL	100%

Project Grading:

The first two submissions of the project will be graded for content only. The final project submission is essentially the first two submissions combined into a coherent report. As a result, the final project submission will not only be graded for content but also it will be graded for presentation (i.e., organization, grammar, spelling, punctuation, neatness, etc.).

Exams:

All tests will consist of objective questions, such as true/false and multiple choice. The purpose of these exams is to evaluate your knowledge of the financial principles discussed in the textbook, handouts, and in class. That is, you are responsible for all of the following:

All the assigned chapters (whether discussed in class or not),

All material discussed in class (whether in the textbook or not),

All material in any handouts

There will be two midterm exams and a final. The final will be comprehensive. All tests will be

closed book. Each exam may have a formula sheet, a copy of which will be posted on **Blackboard** so that you know its contents. You may use a financial calculator in the test *but not* a computer (see important note on calculators above). Furthermore, the memory of your calculator *must be totally empty*.

There will be a review session before the final as shown in the course outline. The office hours the week before the midterm will primarily be oriented to reviewing the relevant material in the coming midterm. In these review sessions, I will answer any questions that you may have about the material. I will not provide a summary or an overview of the material.

You are required to take all tests administered in this course. **THERE WILL BE NO MAKE-UPS FOR TESTS.** If you are unable to take a test, you must obtain my written permission for missing the exam prior to the exam (Detailed requirements are included in Section on **Missed Exam policy** under **Course Policies**). Missed exams receive the grade of zero.

Blackboard Connection:

All course material will be posted in Blackboard. I will use Blackboard for all class-wide communication. You can use Blackboard to download posted material, to receive class-related notices, and to communicate with your classmates. For this to work, every one must know how to access Blackboard.

Because of the importance of Blackboard, the first class session will include a discussion of how to use Blackboard. The Help Desk on the 2nd floor of GBB can help you with any problems you may have with Blackboard.

You will need to know how to access Blackboard in order to obtain the Benninga textbook.

Class Participation:

Class participation is strongly encouraged. It will help you understand the material better, and your questions will usually help others as well. Demonstration of knowledge of course material through verbal participation in class discussions may be a factor in assigning final grades to students in borderline cases.

Grading Policy:

The historical average grade point in previous similar courses has been 2.95. This should be a reasonable expectation of the current course grade average.

Extra-Credit Assignments:

In fairness to all other students, there will be no extra-credit assignments. Requests for extra credit assignments to make up for a poor performance on a test or in the course will not be granted.

Return of Graded Exams and Paperwork:

Returned paperwork, unclaimed by a student, will be discarded after 2 weeks, and will not be available should a grade appeal be pursued by a student following receipt of his/her course grade.

Course Policies:

Requests for incomplete grades, action related to academic dishonesty, and other administrative actions will be handled according to the policies established by the University and the School of Business Administration (SOBA).

Incomplete Policy:

Do not ask for a grade of incomplete for the course simply because you are doing poorly in the class. The University and SOBA have established clear-cut and highly restrictive limitations on when the grade of incomplete can be granted, and what the contractual obligations of the parties entail (see "Academic Policy and Procedures" in the University catalog). Note that an incomplete can only be granted after the 12th week. If you receive an "IN" from this course, you will take your make-up final exam on the second Tuesday from 2:00 to 4:00 PM in the subsequent regular semester.

Academic Dishonesty:

The use of unauthorized material, communication with fellow students during an examination, attempting to benefit from the work of another student, and similar behavior that defeats the intent of an examination, or other class work is unacceptable to the University. It is often difficult to distinguish between a culpable act and inadvertent behavior resulting from the nervous tensions accompanying examinations. Where a clear violation has occurred, however, the instructor may disqualify the student's work as unacceptable and assign a failing mark on the paper. Please refer to the Student Conduct Code for specific information.

Exam Policy:

You are required to take all exams.

All exams are closed book and closed notes.

You are required to follow all instructions given on the cover sheet of each test. Failure to do so may result in not receiving credit for correct answers.

It is your responsibility to check your test to ensure that no pages are omitted. The cover sheet to each test will explain how many pages there are to the test; how many questions are included in the test; and how many points are assigned to each question.

You are responsible to check the number and sequence of the pages of each test. If your test is missing a page, ask for a new test. Requests for re-grades because pages are claimed to have been missing from a test will not be honored.

If you have any questions during a test, raise your hand and ask your question. No discussion with other class members will be allowed during a test.

You may not leave the examination room during the exam and return *for any reason* except a bona fide medical emergency. If you have an illness requiring you to do so, you must inform me ahead of time and bring a doctor's note. Bathroom breaks are not medical emergencies!

You may be asked to change seats during a test. This does not necessarily mean that you are suspected of cheating.

You may be asked to display your calculator's "*memory lost*" or "*memory erased*" message. You may not use that calculator unless you can display that message.

No hats or sunglasses may be worn during a test.

No food or drink will be allowed in the test.

No partial credit will be awarded for objective questions.

The tests will generally be handed back the next class period following the test. Any questions regarding grading of a test must be brought to my attention by 4:00 PM of the day after the test is handed back. There will be no exceptions. Requests for a reread of a question must be made in writing, and returned with the test.

If you allege you have taken an exam (or submitted a project report) but have not received a grade, it is your responsibility to inform me of this problem in writing within one week after the grades are distributed and posted. Any student not following this procedure will receive a zero for the test.

Requests for grade changes for such reasons as "I am only 2 points from a B" or "I need just a few more points to ..." will not be considered.

If you change your answer on the scantron sheet, it is your responsibility to properly erase any other answers you had previously selected. Scantron sheets that are misgraded because of poor erasure marks will not be re-graded.

All grade-inquiry requests must be made in writing within one week after the grades are posted.

Exception to Exam Policy:

The only exception to the above policy involves a student's representing the University as a member of a group, team, or organization in a University sponsored activity (not merely a University sanctioned activity). In such case, the student must advise me in writing at least one week prior to the exam and will be allowed to take the exam prior to the scheduled exam. In no case, will a student be permitted to take an exam *after* the scheduled date of the exam.

Missed Exam Policy:

There will be no make-up exams.

A student must take ALL exams.

If a student does not have a written, acceptable (a common cold is not acceptable), verified excuse for missing either of the midterm exams, or does not give prior notice *even with a valid excuse*, the student will receive a grade of zero for the missed exam.

A missed midterm will receive a grade of zero unless the student does the following:

- (1) a student gives notice to the professor prior to the exam that he or she will be missing an exam, AND,
- (2) a legitimate and verified excuse is presented to the professor within one week after the exam was administered.

If a student has a written, acceptable, verified excuse for missing a midterm exam and has given proper prior notice of the excuse, his or her final exam grade will count for the missed midterm.

Students who miss both midterm exams will automatically receive the grade of "F" for the course, if they have not withdrawn from the course.

Personal Financial Problems Policy:

It is a conflict of interest for an instructor to give personal financial advice to a student in this class. The instructor will not answer personal financial questions.

How Can You Do Well In This Course?

This course has a reputation of being among the more difficult of the core courses in the program. This is primarily due to the nature of the material, which some students find difficult or at least not intuitive. The material for this course can only be absorbed **gradually and consistently**. In my exams, I will frequently ask you to apply your problem-solving abilities to unfamiliar cases. Memorizing the materials will **not** prepare you for the exams. ***Understanding*** the material will.

This course is *definitely* not a *technical* course, in the sense that it is not heavily mathematical. Of course we use numbers and simple equations but these are only tools. This course is *analytic*. This means that the main task is to understand the financial principles behind the few equations and to learn how, when, and where to apply them. It is easy to be misled by the prominence of equations and to believe that learning how to manipulate these equations is the key to success. It is not! The key to success is putting in the time and effort to understand the concepts and their applications.

Here are a few suggestions for effective learning and success in this subject:

1. Read the chapter(s) before you come to the lecture. You may not see all the nuances but you will be ready to learn from the lecture. Read it so you have an idea of what we will be talking about. I cannot stress this enough. If you come to class without having read the chapter(s) you will be at a significant disadvantage.
2. Pay attention to the lecture. I will not simply be going over the chapter(s). I will cover what I think are points that are more important and/or more difficult. I will often present material that is not in the textbook. If you are not paying attention you may miss this material.
3. Read the chapter(s) again after the lecture. You should find this reading a lot easier. At this point you can focus on points that were difficult or confusing.
4. Focus your attention on the lecture and participate as much as you can in the class discussions. (No food or drink will be allowed in class. Beepers and cell phones must be turned off during class meetings.)
5. Ask as many questions as you like in class; this will help both you and your classmates. When others ask questions, ask yourself: Do I know why the question is being asked? Do I know the answer? Does the answer given surprise me?
6. Understand the material. This includes understanding the lecture, the notes, the problems and the solutions, and the text.
7. Work the end-of-chapter problems regularly, and practice the exam review questions and the sample exams on the CD ROM and the McGraw-Hill website. Make sure you *understand* the issues each problem raises and *why* a particular technique applies. Being able to solve many very similar problems by analogy is not going to be very helpful to you. It is far better to search for a variety of problems in order to practice how to apply the concepts. Studying in groups can be very helpful because you have an opportunity to see how others approach problems.
8. Do extra problems. I plan to post the answers to ALL of the Brealey & Myers' end-of-chapter problems. You should do extra problems if you have any difficulty with the material.
9. Use the EXCEL spreadsheets associated with each chapter to reinforce your understanding of the concepts and how they apply, and also to check your answers to additional problems you may

construct.

10. Keep abreast of the current events by reading (at least the cover pages of) the Wall Street Journal.

11. Whenever possible, apply what you have learned to your daily financial life.

12. Finally, I cannot stress enough that it is very critical for you to keep up with the readings and solve problems on a regular basis.

PROJECT DESCRIPTION

In doing this project, the following discussion gives you direction. This project must be typed to be accepted. Everything must be letter quality printed. Each student must choose a *different* firm. Firms will be approved on a first-come, first-served basis. It is your responsibility to assure that your chosen firm fulfills the required characteristics. Choice of firm must be submitted and approved by September 22, 2003.

PART 1

Choose a public company with the following characteristics:

- a. Total annual sales must be less than \$50 billion.
- b. Must have five (5) years of financial statements.
- c. No operating losses (EBIT) in the last five years. Should not have any regular losses in last two years.
- d. Must be a manufacturing or service company. Cannot be a financial institution or real estate company.
- e. More than 80% of its sales should be in its primary industry classification.
- f. The firm must have available an estimation of beta.
- g. Must have SEC filings available on EDGAR.

PART 2

1. Prepare an analysis of the industry to which your firm belongs.
 - a. Describe the characteristics of the industry
 1. Characteristics of industry components
 2. Sales characteristics and growth outlook for long run (at least 5 years)
 - b. Geographic factors (markets, production, other)
 - c. Causes of changes in industry prospects such as:
 1. Competition
 2. Technology
 3. Government (regulation, customer, other)
 4. Price changes and policies

5. Impact of business cycle
d. Summary of industry outlook and what it means to your company

2. Describe your company as follows:

- a. Background and History
- b. Organization of Management
- c. Products
- d. Markets and Distribution Channels
- e. Competition
- f. Production Facilities
- g. Promotional Activities
- h. International Dimension, if any
- i. Other

PART 3

1. For the last five fiscal years, compare the financial information from the various 10Ks and the compilations available on Yahoo Finance, Standard & Poors Market Insight, or other sources. Are they the same? If not, what part or parts are not. Why are they not the same? Which would be the best to use for financial analysis.

2. Using the preferred data source, prepare a five year spreadsheet, using EXCEL, showing the income, balance sheet, and sources and uses of funds statements for the last five (5) years of historical data.

3. Describe the trends in growth and variability of:

- a. Sales
- b. Expenses
- c. Earnings and profit margins
- d. Any unusual income statement items
- e. Current asset utilization
- f. Any unusual current asset item
- g. Fixed and total assets
- h. Current liabilities
- i. Any unusual current liability items
- j. Long term debt and common stock utilization
- k. Elements of cashflow (operations, investment, and financing)
- l. Free cashflows

4. a. Using the industry definition in Yahoo Finance, obtain a listing of the firms in the same industry as your firm.

b. Using the data from these industry firms, prepare a spreadsheet from which you can determine industry ratios for the last five (5) years. Generate the industry ratios for comparisons in (c).

c. Prepare a ratio analysis comparing the firm's ratios to those of the industry for the last five years. The following ratios are a minimum requirement:

1. Liquidity ratios -- Current and Quick ratio
2. Activity ratios -- Accounts receivable turnover, average collection period, inventory turnover, days of inventory, sales/working capital, total asset turnover, fixed asset turnover.
3. Debt ratios -- Total Debt/Total Assets, total debt/net worth, Time Interest Earned
4. Profitability -- Profit BT/Total assets, gross margin, Profit BT/Sales, Profit BT/Net Worth
5. Any other ratios of importance.

d. You must graph at least one ratio in each category.

Choose the ratios which are the most important for your company.

e. Prepare an overall analysis of the results of the ratio analysis and what they mean to your company.

PART 4

4. In order to evaluate project opportunities, it is necessary to determine the cost of capital, k_o , where the cost of capital is as follows:

$$k_o = [\{ D/V \} \times k_d \times (1-t)] + [\{ E/V \} \times k_e]$$

where: $k_e = R_f + \beta (E(R_M) - R_f)$

R_f = Long-term risk-free rate

β_e = Beta, obtained from public sources

R_M = Expected Return on the Market

k_d = Cost of debt

D = Market value of debt

t = Effective tax rate

E = Market value of firm's equity

V = Market Value of the firm

Some of these variables will vary day-by-day while others tend to be more constant over time. As a result, it is necessary to choose a date for your analysis (say, for example, October 31, 2003).

- a. What date will be used for your analyses?
- b. What is your firm's β_e ?
- c. What is the expected return on the market?
- d. What is the long-term risk-free rate as of the date you choose for all of your analyses?
- e. What is the market value of your firm's equity, E?
- f. Using the information about your firm's interest payments from the most recent balance sheet and income statement compute your firm's cost of debt?
- g. The financial statements notes and the 10K may provide some information on your firm's debt costs which may be an alternative to computing the firm's cost of debt. Compare this information to the previous calculation.
- h. Using EXCEL spreadsheets, prepare a determination of the market value of your firm's debt.
- i. Use information about your firm's taxes to compute your firm's effective tax rate.
- j. What is your firm's weighted average cost of capital?

PART 5

For the same date as used in Part 4:

- a. Using the same firms as used in Part 3 (4), using EXCEL: . Prepare an estimate of industry Price/Earnings, Price/Sales, Price/ Book Value, and Price/ EBITDA ratios.
- b. Using these ratios, estimate the various indicators of value of your company.
- c. Based on these results, reconcile the different indicators of value and prepare a final determinant of value.
- d. Compare the value obtained to the price of the stock on the date you chose for analysis and indicate whether the stock appears to be under-, over-, or fairly priced and why you think so. For purposes of this analysis, Earnings is defined as Earnings After Tax and EBITDA is defined as earnings before interest, taxes, depreciation, and amortization.