

P R I S T I N E

Financial Reporting and Analysis - IV

Key issues in Financial Reporting Quality: Red Flags and Accounting Warning Signs

- Incentives to Over-report or under-report earnings
- Activities resulting in a low quality of earnings
- Fraud Triangle
- Risk factors related to incentives and pressures leading to fraudulent accounting
- Risk factors related to Opportunities leading to fraudulent accounting
- Risk factors related to Attitudes and Rationalization leading to fraudulent accounting
- Common accounting warning signs and detecting each
- Accounting warning signs related to the Enron Scandal
- Accounting warning signs related to Sunbeam Scandal

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Incentives to Over-report or under-report earnings

- Incentive for Over-reporting the earnings:
 - Management incentive is linked to earnings which they would like to overstate
 - Keep actual earnings above or meet expectations
 - To keep earnings within limits of debt covenants
- Incentive for Under-reporting the earnings:
 - To get favourable terms and conditions from creditors
 - To get favourable terms and conditions from labor unions
 - To get trade relief through quotas and productive tariffs

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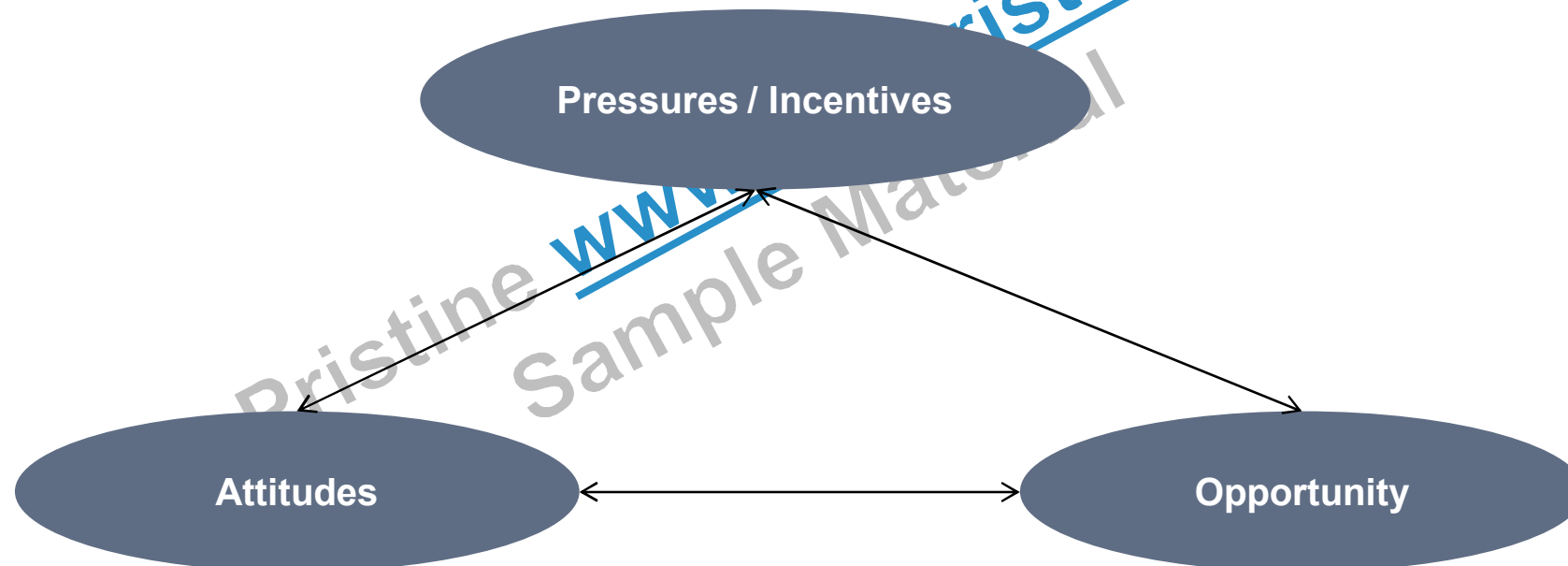
Activities resulting in a low quality of earnings

- Adopting accounting principles not consistent with economics
 - A depreciation method / or inventory method not consistent as per economics
- Unrealistic / aggressive assumptions and estimates
 - Bad debts rate or depreciation rate with modified age and salvage value
- Playing with structure of a transaction to get desired outcome
 - Operating lease instead of capital lease
- Exploring accounting principles
 - Improving leverage ratio by not consolidating SPV

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Fraud Triangle

- Presence of generally 3 conditions for fraud to occur known as fraud triangle
 - Pressure / Incentive a cause for frauds
 - **Mindset and attitudes** justifying frauds
 - Weak internal controls provide an **opportunity** to commit frauds



Risk factors related to each of these 3 conditions is discussed in following slides

- **Threat to financial stability and profitability** caused due to:
 - Falling customers demand
 - Increasing competition
 - Technological changes causing obsolescence
 - Regulatory changes
 - Operating losses and negative margins
 - Negative cash flows
- **Third party pressures** like from:
 - Debt repayment obligation and covenants
 - Unrealistic profitability expectations
 - Stock exchange listing requirements
 - Debt or equity financing

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- **Internal pressure on management from**
 - Meeting Sales targets
 - Meeting profitability targets
- **Management's personal interest**
 - Compensation linked to profitability
 - Stock options / stake in company
 - Personal guarantees on debt taken by management

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- **Nature of firm's industry like**
 - Presence of non arm length transactions due to
 - Opportunity to decide terms and conditions with suppliers / customers resulting
 - Significant related party transactions
 - Presence of bank accounts in tax havens
 - Presence of significant judgment and estimates in presenting FSs
 - Presence of complex transaction – substance over form
- **Complex organizational structure**
 - High turnover at higher management and board
 - Unusual legal entities and authorities
 - No clarity on control
- **Weak internal controls as appears from**
 - High turnover of accounting and informational technology personnel
 - Inadequate internal control
- **Inefficient management reporting as appears from**
 - Ineffective control of Board of Directors and its committees
 - Single person or few people dominating management

Related to corporate governance practices like

- Inappropriate ethical standards
- Management is very inclined towards increasing share prices
- Third party commitments to achieve aggressive results
- Nonfinancial management having excessive participation
- History of regulation violation
- Unpleasant relationship between management and auditors causing frequent disputes, restriction on auditors access and limiting management ability to communicate with BOD
- Manage earnings to minimize taxes
- Using inappropriate accounting policies on account of materiality concept

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- **Different revenue and operating cash flow growth rates**
 - Earning manipulation if no stable relationship between net income and operating CF
 - Relationship can be measured by operating CF / net income; declining ratio is an issue
 - Declining cash flow on face of growing earning may be a result of aggressive revenue policy or conservative expense recognition policies
- **Aggressive revenue assumption:** Recognizing revenue early for example
 - Posting back dated entry in past year after accounting period has closed
 - Recognizing revenue before goods are delivered a.k.a bill and hold policies
 - Recognizing revenue before all terms and conditions fulfilled
- **Abnormal growth compared to industry / economy**
 - Though it reflect better marketing abilities and good management
 - It is cause of concern when receivables are growing faster than sales
- **Abnormal gross / operating margin compared to industry / economy**
 - Shows better management on the face, but reality should be checked looking into accounting policies; better performance may be caused due to accounting irregularities
- **High revenue growth from non operating income / non recurring gains**
 - Incorrect classification of these items as revenue does not show a real picture
- **Delaying expense recognition**
 - Capitalisation instead of expensing and boosting up current net income

Common accounting warning signs and detecting each (Cont...)

- **Low expenses on face of high extraordinary / non recurring expenses**
 - By moving expenses from ordinary to extraordinary
- **Abnormal inventory growth compared to sales growth**
 - Causes lower COGS and higher profit; however this may be a result of obsolete products which should be written off
- **LIFO liquidation**
 - During rising prices, It causes lower cost of goods sold & higher profits which is not sustainable
- **Use of operating leases**
 - Structure finance leases as operating leases as a source of off balance sheet financing causing low leverage ratio
 - Such leases should be compared with other industry players
- **Extending the useful life of assets**
 - Less depreciation and higher earnings, compare useful live with other industry peers
- **Aggressive pension assumptions**
 - High discount rate, high pension expected return and low wages growth rate decreases obligation and increases earnings; compare with other industry peers
- **Equity method investments**
 - What's happening with companies known as SPV and impact if consolidated
- **Off balance sheet items**
 - May be a very significant liabilities are outstanding hence should be watched closely