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
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
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
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*
Risk factors related to incentives and pressures leading to fraudulent accounting

- **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
Risk factors related to incentives and pressures leading to fraudulent accounting (Cont...)

- **Internal pressure on management from**
  - Meeting Sales targets
  - Meeting profitability targets

- **Management’s personal interest**
  - Compensation liked to profitability
  - Stock options / stake in company
  - Personal guarantees on debt taken by management
Risk factors related to Opportunities leading to fraudulent accounting

- **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
Risk factors related to Attitudes and Rationalization leading to fraudulent accounting

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
Common accounting warning signs and detecting each

- **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