

ACCOUNTING RED FLAGS

Companies have many choices they can make when it comes to reporting their financials: The Generally Accepted Accounting Principles are not iron-clad.

Your job as a journalist is to figure out where they're following the rules, but applying GAAP liberally.

Red Flag #1

- When a company starts bashing short sellers.
- Example: In April 2000, Enron CEO called hedge fund manager Richard Grubman an a--hole during a conference call with analysts and investors. That day, the stock closed at \$60. Less than eight months later, the company was filing for bankruptcy, costing investors billions.
- How to find: Listen in on Q&A section of analyst conference call.

Red Flag #2

- When you read the SEC filings and still can't seem to understand what's going on.
- Example: In Enron's now infamous Footnote 16, it was easy to see something unusual was going on, but hard to figure out what it was. If you don't understand something, there's a good chance the company is *trying* to make it difficult to understand.
- How to find: Look for long uninterrupted strings of text.

Red Flag #3

- When you see lots of new footnotes and disclosures, particularly of things that happened years ago.
- Examples: HCA has repeatedly changed its disclosure on some insider real estate deals; Tyson did so on cattle ranchers lawsuit
- How to find: Compare 10-Ks and 10-Qs for prior years and quarters, side by side.

Red Flag #4

- When companies count revenue when items are simply shipped, or they are using a percentage-of-completion method.
- Example: Bristol-Myers Squibb overstated \$2.5 billion in revenues and \$900 million in earnings between 1999 and 2001 by giving incentives to move product before the end of its quarters.
- How to find: Footnote on significant accounting policies.

Red Flag #5

- When there are big gaps between numbers in the press release and in the 10-K/10-Q. Regulation G makes this harder for companies to do today, but it still happens.
- Example: Too many to name, particularly during the Internet boom.
- How to find: Compare earnings in press release to numbers in K and Q filings.

*****This handout is supplemental material – Used at discretion of presenter*****

Red Flag #6

- When companies seem to take special charges/gains, quarter after quarter and year after year.
- Examples: Cendant, Kodak, Edison International, HCA, Weyerhaeuser. Each of these companies took a special charge/gain in each of the 20 quarters between 1998 and 2002.
- How to find: Unfortunately, no easy way to detect patterns other than by tracking it manually, or by spreadsheet.

Red Flag #7

- When companies are only able to report net income by not expensing stock options. Also: companies that change the assumptions for calculating stock option expenses.
- Examples: Dell, Apple, Broadcom.
- How to find: Two places – first or second footnote, and footnote on stock options.

Red Flag #8

- When there are lots of related party transactions with officers and directors. Just because the transaction seems small, don't dismiss it as being insignificant.
- Examples: Too many to name – companies seem to be disclosing even very small deals these days.
- How to find: Proxy statement.

Red Flag #9

- When publicly traded companies are still run like family businesses.
- Examples: HCA, IDT, Friedman, Billings & Ramsey, Hovnanian.
- How to find: Proxy statement.

Red Flag #10

- When there are lucrative consulting contracts/severance agreements with current and/or former directors and executives.
- Examples: Gannett, Stanley Works, Tenet.
- How to find: In the exhibits section of 10-Ks and 10-Qs, and in proxy statements.

Red Flag #11

- When there are big increases in director's fees or perks.
- Examples: Peoplesoft, SBC.
- How to find: In the director's compensation section of the proxy statement.

Red Flag #12

- When there's an inattentive audit committee.
- Examples: Enron, WorldCom, Healthsouth.
- How to find: In the proxy statement, it will always say how often the audit committee met. They should meet a minimum of four times a year. In 2002, Qwest's audit committee met 26 times.

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Red Flag #13

- When there's a sizable increase in non-audit fees paid to the accounting firm.
- Examples: Enron, Healthsouth.
- How to find: In the proxy statement, under breakdown of audit/accounting fees.

Red Flag #14

- When the interest rate return on pension fund seems unusually high, or when 20 percent or more of operating income comes from pensions
- Examples: Weyerhaeuser, IBM, GM (interest rates) and Raytheon, Lockheed Martin, and Verizon (20 percent or more of operating income).
- How to find: Buried in the footnote on pensions.

Red Flag #15

- When there are off-balance sheet obligations that had not been previously disclosed.
- Examples: McDonald's, Williams-Sonoma, Mesa Air.
- How to find: Search in filings for words like "special purpose entity" or "off-balance sheet."

Red Flag #16

- When you see amended SEC filings (Ks, Qs): Just because a company files its 10-K or 10-Q doesn't mean that's the final word. You need to be on the lookout for revised filings, particularly if they're being revised due to SEC investigations/
- Examples: Time-AOL, Kodak, Computer Associates.
- How to find: Set up an e-mail notification for new filings from your company.

Red Flag #17

- When you see the words "formal" or "informal investigation," "subpoena" or "Wells notice."
- Examples: Doubleclick, Cardinal Health, WebMD.
- How to find: Often disclosed in an 8-K filing with updates buried in Ks and Qs.

Red Flag #18

- When there are unusual income tax rates – either unusually low or unusually high. Rates should fall between 30 percent and 40 percent.
- Example: Global Crossing had an effective tax rate of 108 percent in 1999, the year before it collapsed.
- How to find: Footnote on income tax

Red Flag #19

- When companies shrink the number of reporting segments or only report one segment.
- Examples: Sun Microsystems, Corinthian Colleges.
- How to find: Usually in the last footnote in the 10-K.

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Red Flag #20

- When there are new lawsuits/legal disclosures and/or risk factors.
- Examples: Halliburton, RJR, Peoplesoft.
- How to find: In the “Risk Factors” or “Legal Proceedings” sections of the 10-K (also sometimes in the 10-Q).

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