

## **INTERMEDIATE FINANCIALS and ACCOUNTING RED FLAGS**

### **Securities and Exchange Commission (<http://www.sec.gov>)**

- Created in wake of 1929 crash to restore faith in the financial markets
  - To protect investors by requiring companies to disclose certain financial information through various filings
  - To maintain investor confidence
  - To maintain a fair and orderly trading market
- Who files with the agency?
  - Companies with more than \$10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports.
  - Many private companies with more than 500 shareholders or debt offerings.
  - Foreign companies whose shares may be traded on a U.S. exchange via American Depository Receipts, or ADRs.
- SEC Challenges
  - 15,000+ public companies
  - Around 4,000 employees – small by federal agency standards
  - Twice the turnover of the average government agency
  - 2.5 years average tenure of an SEC attorney
  - For three years before Enron’s bankruptcy, SEC did not review its filings

### **Sarbanes-Oxley Act**

- Passed in 2002 after scandals, such as Enron, Arthur Anderson, WorldCom, etc.
- To protect investors by improving reliability and accuracy of corporate disclosure
- Considered most significant change to federal securities laws since the New Deal
  - Radically redesigned federal regulations of public company governance and reporting obligations.
  - Significantly tightened accountability standards for directors and officers, auditors, securities analysts and legal counsel.
- [www.aicpa.org/info/sarbanes\\_oxley\\_summary.htm](http://www.aicpa.org/info/sarbanes_oxley_summary.htm) – An excellent overview of the Sarbanes-Oxley Act
- Sarbanes-Oxley and private companies
  - Although SOX applies only to public companies, numerous private companies and not-for-profits are adopting its guidelines.
  - Most activity is in area of governance.

### **Public Company Accounting Oversight Board (<http://www.pcaobus.org>)**

- Created by Sarbanes-Oxley Act as an independent group to oversee accountants
- Sets rules on “auditing, quality control, ethics, independence and other standards.”
- Conducts investigations and disciplinary proceedings
- Enforces compliance with the Sarbanes-Oxley Act

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

## **What Is What**

- SEC: Securities and Exchange Commission
- PCAOB: Public Company Accounting Oversight Board
- FASB: Financial Accounting Standards Board
- GAAP: Generally Accepted Accounting Principles
- GAAS: Generally Accepted Auditing Standards
- AICPA: American Institute of Certified Public Accountants

## **Generally Accepted Accounting Principles (GAAP)**

- Financial reporting guidelines that are based on theory and practice
  - So can be vague and ambiguous, and can lead to different interpretations
  - Evolved over time
  - They're procedures, concepts and standards
- GAAP Assumptions – basic financial accounting assumptions
  - Periodicity: information prepared and reported in specific time periods
  - Going concern: business will operate for the foreseeable future
  - Economic entity: separate, distinct financial entity from other businesses
  - Monetary unit: results are recorded in monetary units, i.e. dollars
- GAAP Principles – principles as a result of those basic assumptions
  - Full disclosure: necessary information is disclosed in understandable form
  - Matching: revenues and expenses are matched in period earned and incurred
  - Historical costs: assets reported at original cost, without a markup in value
  - Revenue realization: revenue reported when everything goes into creating revenue is completed
  - These principles give Consistency to financial statements. Changes to principles will be noted in Footnotes to a company's Annual Report (10-K).
- GAAP Considerations – commonly observed modifications to GAAP principles
  - Materiality: the information an investor needs to make an informed decision
  - Industry practices: accepted industry practices often trump GAAP
  - Conservatism: in equally acceptable principles, companies should opt for the more conservative practice

## **Strategy for Reading Annual Reports (10-K's)**

- First, look at the auditor's report
- Next, look at financial data (income statement, balance sheet, cash flow statement)
- Next, match the financial data to the Footnotes, which explain and/or elaborate on the numbers, or on changes in the way they're reported.
- Then read the Management's letter
- Then read the Management's discussion and analysis

## **Cash or Operating Cycle**

- Start with cash in the form of:
  - Cash
  - Receivables
  - Debt

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

### **Cash or Operating Cycle (cont'd)**

- Then use the cash to purchase inventory
  - Raw materials
  - Work in progress
  - Finished goods
- Then use the inventory to produce product
- Then sell product in return for:
  - Accounts receivable (collections)
  - Cash
    - Collect receivables as cash
- Use those returns to pay off accounts payables (bills)
- Start over

### **Accrual Method of Reporting Revenues**

- Reporting concept that requires revenues to be reported in the fiscal period in which they are earned and expenses to be reported as they are incurred.
  - Records revenues as soon as the “sale” occurs
  - Records expenses as soon as the bill is received
- In other words, transactions enter the financial records when they occur, not when cash actually changes hands.
- Accrual method, therefore, shows “scores,” not real spendable dollars

### **About Corporate Numbers: They’re Squishy Because:**

- Goods will not necessarily be paid for, or be kept by buyer.
- Inventory might be out of date, obsolete or unable to be sold
- Status of some inventory may be uncertain
- Machinery or other fixed assets might be obsolete or falling apart before expected
- Accounting conventions
- Timing issues
- Bottom line: In many ways, statements are a collection of estimates.
- And because they’re squishy:
  - Companies create reserves, or allowances, to compensate.
  - You don’t see reserves? Be alert!

### **BALANCE SHEETS**

- Snapshot of financial activity at a point in time.
- It balances
- $Assets = Liabilities + Shareholders' Equity$

### **Assets**

- Current assets
  - Cash and cash equivalents (can be converted to cash within 90 days)
  - Accounts receivable
  - Inventories
  - Prepaids

### **Assets (cont'd)**

- Investments and other assets
- Property, plant and equipment, net
  - Land, buildings and improvements to both
  - Equipment
  - Companies calculate in estimated depreciation of these assets in their books
- Goodwill and other intangibles
  - Difference between what a firm pays to buy another company and the book value (total assets minus total liabilities) of that company.
  - Has been written off over time, typically 40 years
  - In future, will no longer be amortized, per 2002 FASB rule change (amortization = accounting procedure that gradually reduces a statement's cost value through periodic changes to income)
    - Now will use impairment testing (writing down to market value)
    - Other intangible assets to continue to be amortized

### **Liabilities**

- Current liabilities
  - Accounts payable
  - Accrued liabilities
  - Income taxes
  - Current maturity of long-term debt
- Non-current liabilities
  - Long-term debt
  - Deferred income taxes
- Commitments and contingencies

### **Shareholders' Equity**

- Capital stock
  - Both Preferred and Common stock
- Additional paid-in capital
- Retained earnings
- Treasury stock
  - Total shareholders' equity
  - Total L + OE

### **INCOME STATEMENT**

- Also known as
  - Statement of earnings
  - Statement of operations
  - Statement of income and comprehensive income
- Like a motion picture. Covers a period of time, typically a quarter or a year
- Reports income from ongoing activities, as well as other activities beyond management's control (comprehensive income)
- Involves estimates

**Basic Income Statement Consists of:**

- Sales or revenues
- Cost of goods sold
- Gross profit
- Operating expenses, include:
  - Sales, general and administrative (salaries, etc.)
  - Depreciation, amortization
- Operating profit
- Income taxes
- Net profit after taxes (proverbial “bottom line”)
- Other considerations
  - Discontinued operations
  - Extraordinary items
  - Changes in an accounting principle
  - Other changes, such as depreciation
- Earnings per share (typically refers to common stock)
  - Basic earnings per share (Bloomberg uses)
  - Diluted earnings per share (*The Wall Street Journal* uses)

**CASH FLOW STATEMENT**

- Like a bridge. Shows how the balance sheet has changed from the end of one fiscal year to the next, in terms of their effect on cash.
- Record of cash provided by *cash sources* and of cash consumed by *cash uses*.
- Information about investing and financing
- Shows ability to continue as a going concern
- Shows ability to generate future positive cash flows
- Shows ability to meet obligations and pay dividends
- Has received a lot of attention in recent years, after the bubble burst
- Shows cash flows
  - From operations
  - From investing
  - From financing

**Flexibility**

- Companies have some flexibility in categories for entries on cash flow statement.
- Total change in cash, however, will not change.
- Overwhelming majority of accounting standards deal with balance sheet and income statement, not cash flow statements.

**Free Cash Flow**

- Powerful tool for making a company successful and powerful indicator for investors
- Cash that is left over after the productive capacity is maintained
- Permits expansion, paying down debt, buying back shares, etc.

### **Free Cash Flow (cont'd)**

- Several ways to calculate it. Companies create their own models. The easy way:
  - The gross way:
    - Take cash flow from operating activities
    - Subtract capital expenditures
    - That equals Free Cash Flow
    - If there's too little, that could mean imminent demise.
  - American Standard Model
    - Take cash from operating activities
    - Subtract capital expenditures
    - Add proceeds from disposal of property
    - Add proceeds from sale and leasebacks
    - That equals Free Cash Flow

### **When Looking at the Numbers:**

- Note changes in amounts year to year, especially revenues and expenses.
- Note numbers that are significantly larger or smaller than the previous period.
- Look at trend line for sales/revenues, operating income and net income. Calculate the percentage change for each.
- Look at cash flow.
- Look at free cash flow.
- Tie the numbers to the footnotes.
- Be wary of “One-time Gains” that reoccur
  - Don't be fooled by extraordinary items that make net income look better than it really is
  - Extraordinary items should be both unusual in nature and infrequent in occurrence.
  - Examples: Writedowns, restructurings, etc.
- Techniques for studying numbers
  - Calculate percentage change, year over year
  - Trend analysis
  - Comparative ratio analysis (common size analysis)
  - Calculate key ratios

### **Examine Companies With the...**

- Steepest decline in cash flow from operations (CFFO) relative to net income
- Greatest year-over-year sales growth, followed by declining or negative growth
- Greatest growth in receivables relative to sales
- Big increases in “soft” assets
- Big increases in deferred revenue
- Biggest and smallest deterioration in gross margins
- Largest bulge in inventory relative to sales and to cost of sales

### **Pro Forma Results**

- Expenses against earnings are not standardized across an industry
- They're selectively defined earnings

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

### **Pro Forma Results (cont'd)**

- Common pro forma: Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)
- Recommendation: GAAP results should precede pro forma results in earnings releases
- Headlines should show GAAP earnings
- SEC's Regulation G (1/03) states that non-GAAP numbers used in an earnings release must be accompanied by, and reconciled with, the "most directly comparable" GAAP number
- Pro forma has value for companies
  - "As a matter of form"

### **Footnotes and Red Flags**

- First note is a summary of significant accounting policies, such as:
  - Cash and cash equivalents
  - Short-term investments
  - Inventories
  - Property, plant and equipment
  - Goodwill
  - Accounting pronouncements
  - Revenue recognition
- Other income
- Debt
- Financial instruments
- Short-term borrowings
- Supplemental income/cost information
- Taxes
- Inventories
- Earnings per share data
- Commitments and contingencies
- Quarterly financial information

### **Auditor's Report Historically**

- Independent auditor's opinion on whether financial statements are presented fairly in all material respects, in accordance with GAAP
- Basic Auditor's Report
  - It says we (auditors) looked at these statements
  - We followed the rules in our audits and here's what an audit involves
  - They're management's responsibility; we're just here to express our opinion
  - In our opinion, the statements fairly present the company's position
  - Auditor's Report by Category:
    - Clean/Unqualified: Financial statements fairly present company's position (majority of the opinions are this)
    - Qualified: In general, statements are fairly presented with a notable exception or two. Look for phrases like "except for" or "subject to."

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

**Auditor’s Report: Categories (cont’d)**

- Disclaimer: Auditor can’t give an opinion because the audit was so restricted by the company.
- Adverse: Auditor finds that company statements are presented unfairly (rare, but definitely a story)
- New Auditor’s Report
  - Combines traditional report with internal controls requirement of Sarbanes-Oxley Act
    - Traditional independent auditor’s opinion
    - Management’s report on its assessment of effectiveness of company’s internal control over financial reporting
  - Independent auditor’s report on internal control over financial reporting, including auditor’s opinions on the following:
    - Whether management’s assessment is fairly stated in all material respects (i.e., whether auditor agrees with management’s conclusions regarding the effectiveness of internal control over financial reporting)
    - Effectiveness of company’s internal control over financial reporting

**Reporting Options**

- Management’s Report: Effective, not effective
- Auditor re Management Assessment: Unqualified, adverse, disclaimer
- Auditor re Management Effectiveness of ICR: Unqualified, adverse, disclaimer
- Auditor re Financial Statements: Unqualified, qualified, disclaimer

**Reporting Scenarios**

**Most Likely Reporting Scenarios -- Internal Control over Financial Reporting**

	Auditor’s Report			
	Management’s Report	Management’s Assessment	Effectiveness of ICR <sup>2</sup>	Financial Statements
No material weakness identified	Effective	Unqualified	Unqualified	Unqualified
Material weakness identified by management and by the auditor	Not Effective	Unqualified	Adverse	Unqualified <sup>1</sup>
Material weakness identified by the auditor, not by management <sup>3</sup>	Effective	Adverse	Adverse	Unqualified <sup>1</sup>

1. Presumes the auditor is able to perform sufficient procedures to conclude that the financial statements are fairly stated  
 2. Internal control over financial reporting  
 3. In this situation, management and the auditor disagree on whether a control deficiency constitutes a material weakness. See also Question No. 27.

**Revenue Recognition**

- Should be recognized after earnings process is completed and an exchange has occurred.
- Goods ordered, but not shipped?

### **Revenue Recognition (cont'd)**

- Goods shipped, but not ordered?
- SEC criteria for revenue recognition
  - Persuasive evidence of an arrangement
  - Delivery has occurred or services have been rendered
  - Seller's price fixed or determinable
  - Collectibility is reasonably assured
- Watch accounts receivable
  - Unusual increases in AR
  - Long-term receivables
  - Look at collectibility of accounts
  - Seller-provided financing
  - Extended payment terms, especially on new products
  - Customers whose financing is uncertain

### **Other Important Considerations in Financial Statements**

- Impairment
  - For much goodwill, now use “impairment testing”
  - The impairment is expensed on the income statement
- Amortization
  - No specific guidance for appropriate amortization period for long-lived assets.
  - Therefore, management has much discretion over reported results.
  - Longer amortization periods lower periodic expense and raise pretax earnings.
- Capitalizing vs. Expensing
  - Capitalize costs that produce a future benefit. Record as asset, then charge as expenses when the benefits are received. (Plant and equipment)
  - Expense costs that produce a short-term benefit. (Rents and salaries)
  - Aggressive Capitalization
    - Reporting current-period expenses and/or losses as assets
    - So expense recognition is postponed, boosting current-period earnings
- Restructuring and Special Charges
  - Generally, a charge can't be recognized and liability entered until management officially commits to a restructuring plan.
  - Footnote should summarize changes to restructuring-related liability accounts.
  - Activity reported in annual and quarterly filings
- Inventories
  - The main way to value inventory is by cost
  - First-in, first-out (FIFO)
    - Most closely parallels physical flow of units in most industries
    - Results in higher profits, lower cost of goods sold and higher value of ending inventory
  - Last-in, first-out (LIFO)
    - Results in lower profits, higher CGS and lower value of ending inventory.
  - Look at the trends in inventories.

### **Other Important Considerations: Inventories (cont'd)**

- Increase in raw material might mean business is speeding up.
- Increase in finished goods might mean that demand has slowed.
- If inventory grows faster than revenue, could indicate weakening demand.
- Depreciation
  - Examine any change in depreciation models or assumptions for its impact.
- Reserves
  - Examine reserves, and changes in those reserves, for their impact.
- Options
  - Their impact
    - Companies will have to start reporting impact of options in the bottom line of their income statements.
    - Companies currently report a pro-forma version, typically in Footnote 1 of the 10-K/Annual Report.
  - To expense or not to expense
  - Problem with options
    - The cost of the options to the company, and therefore impact on profits
    - Dilution
    - Cost of buying back the stock to reduce dilution's effects

### **Restricted Stock**

- Stock has a “restriction,” such as requiring a certain length of time to pass or a certain goal to be achieved before the stock can be sold.
  - Called the “vesting period.”
  - Stock is awarded if an employee stays with the company for two years. Or when gross sales hit \$10 million.
- Options vs. Restricted Stock
  - The difference is at end of the vesting period.
  - When a stock option vests, you can purchase or not purchase the stock at a specific price (called the “strike price”). You do not own any stock until you exercise the option and purchase the stock. As soon as you purchase it, you can do anything you want, including sell it.
  - When a restricted stock award vests, you own the stock and you can do whatever you want with it.
  - Generally, restricted stock awards are about one-half to one-third as large as options.
  - Example: If a stock option grant were 100 shares, a restricted stock award would range from 33 to 50 shares. This is because at the end of the vesting period, the 33 to 50 shares would still have some value and the 100 stock options might not.
  - For more information, see:  
<http://management.about.com/cs/money/a/ResStkFAQ1203.htm>

### **Auditor's Fees**

- In general, a company's auditor can not do consulting work with that company.
- Auditor's fees typically are found in a chart in the Proxy Statement.

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

### **Commitments, Contingencies and SPEs**

- Commitments: Long-term purchase deals, outstanding loans, lines of credit, lease arrangements, etc.
- Contingencies: Company could gain or lose from a past transaction or event.
- SPE: Special purpose entity

### **Related Party Transactions**

- All related party transactions should be examined. Especially note how past commitments have changed, or if new ones have been made.
- Note family members who work for the company
- Note payment for use of personal property
- Note consulting fees or vendor deals with family or board members
- Found in the Proxy Statement

### **Pensions**

- Look for actuarial present value of benefits
- Look for interest rates
- Especially, look for expected returns on assets (assumed rate of return)
- What to watch for:
  - Fair value of plan assets
  - Projected benefit obligation
  - Difference between the two

### **Postretirement Benefits**

- Major liability for many companies, but often overlooked by reporters.
- Among other things, look for obligation at the end of year, amount of assets remaining and underfunded amount.
- These are funded out of current operations

### **Differential Disclosure**

- What the company says in one document could be different from or less complete than what it says in another.
- There might be more complete or supplemental information on the topic elsewhere.

### **Key SEC Documents**

- 10-K: Annual Report
- 8-K: Material Events
- 10-Q: Quarterly Report
- Proxy Statement
- Prospectus

### **Accounting Tricks**

- Income Smoothing
  - A form of earnings management designed to remove peaks and valleys from a normal earnings series.

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

### **Accounting Tricks (cont'd)**

- “Big Bath”
  - Wholesale write-down of assets and liabilities in an effort to make the balance sheet particularly conservative, so there will be fewer expenses to serve as a drag on earnings in future years.

### **Executive Compensation**

- Found in proxy statement
- Form 4
- Note deferred compensation (*Wall Street Journal* of Oct. 11, 2002)

### **Earnings Management**

- Using GAAP flexibility to guide earnings toward a predetermined target OR manipulating earnings toward a predetermined target
  - Why? Preoccupation with meeting Wall Street expectations
  - Result: Not meeting target results in stock price decline
- Depreciation
  - Changing depreciation methods
  - Changing useful lives used for depreciation
  - Changing estimate of salvage value for depreciation
- Estimating write-downs
- Estimating impaired assets
- Changing pension assumptions
- Special charges
- Quarter-by-quarter comparison
- Offsetting increases/decreases
- Sources of margin changes
- Trends in revenue, expenses
- Announcing accounting changes just before the end of the quarter
- Suspicious disclosures
- Unusual, nonrecurring items
- Fourth-quarter adjustments
- Review explanations
- Greater detail on reserves
- Major areas of judgment

### **Aggressive Accounting**

- Choosing “aggressive” policies designed to improve profitability
- Revenue recognition
  - After “sale” vs. at “sale”
- Depreciation choices
  - Accelerated, short period vs. straight-line, longer period
- Inventory
  - LIFO vs. FIFO

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

### **Aggressive Accounting (cont'd)**

- Amortize goodwill
  - Shorter period vs. longer period
- Estimate of bad debts
  - High estimate vs. low estimate
- Treatment of advertising
  - Expense vs. capitalize

### **Early Warning Signs**

- Weak control environment
- Management facing extreme competitive pressure
- Management known or suspected of having questionable character (i.e., Al Dunlap)
- Types of Companies to Watch
  - Fast-growth companies whose real growth is beginning to slow
  - Basket-case companies that are struggling to survive
  - Newly public companies
  - Private companies

### **Qualitative Screening**

- <http://www.10kwizard.com>
- <http://access.edgar-online.com>
- Key Search Phrases
  - Change in accounting estimate or principle
  - Financing or extended credit terms
  - Changes in accounting policies
  - Changes in account classification
  - Change in auditors
  - Extended payment terms
  - Percentage of completion
  - Unbilled receivables
  - Bill and hold
  - More liberal credit terms
  - Insider stock sales
  - Decline in backlog
  - Layaway sales
  - Nonmonetary transactions
  - Related-party transactions

### **COMPILED BY:**

James K. Gentry, professor and former dean  
School of Journalism and Mass Communications, University of Kansas  
[jgentry@ku.edu](mailto:jgentry@ku.edu)