

Financial Reporting “Red Flags” and Key Risk Factors

Red Flags

- Complex business arrangements not well understood and appearing to serve little practical purpose.
- Large last-minute transactions that result in significant revenues in quarterly or annual reports.
- Changes in auditors over accounting or auditing disagreements (i.e., the new auditors agree with management and the old auditors do not).
- Overly optimistic news releases or shareholder communications, with the CEO acting as an evangelist to convince investors of future potential growth.
- Financial results that seem “too good to be true” or significantly better than competitors - without substantive differences in operations.
- Widely dispersed business locations with decentralized management and a poor internal reporting system.
- Apparent inconsistencies between the facts underlying the financial statements and Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) and the President’s letter (e.g., the MD&A and letter present a “rosier” picture than the financial statements warrant).
- Insistence by the CEO or CFO that he/she be present at all meetings between the audit committee and internal or external auditors.
- A consistently close or exact match between reported results and planned results – for example, results that are always exactly on budget, or managers who always achieve 100 percent of bonus opportunities.
- Hesitancy, evasiveness, and/or lack of specifics from management or auditors regarding questions about the financial statements
- Frequent instances of differences in views between management and external auditors.
- A pattern of shipping most of the month’s or quarter’s sales in the last week or last day.
- Internal audit operating under scope restrictions, such as the director not having a direct line of communication to the audit committee.
- Unusual balance sheet changes, or changes in trends or important financial statement relationship – for example receivables growing faster than revenues, or accounts payable that keep getting delayed.
- Unusual accounting policies, particularly for revenue recognition and constant deferrals – for example recognizing revenues before products have been shipped (“bill and hold”), or deferring items that normally are expensed as incurred.
- Accounting methods that appear to favor form over substance.
- Accounting principles/practices at variance with industry norms.
- Numerous and/or recurring unrecorded or “waived” adjustments raised in connection with the annual audit.

- Use of reserves to smooth out earnings – for example, large additions to reserves that get reversed.
- Frequent and significant changes in estimates for no apparent reasons, increasing or decreasing reported earnings.
- Failure to enforce the company’s code of conduct.
- Reluctance to make changes in systems and procedures recommended by the internal and/or external auditors.

Risk Factors*

Risk Factors Relating to Management Characteristics

- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.
- A significant portion of management’s compensation represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results or financial position.
- An excessive interest in maintaining or increasing the entity’s stock price or earnings trend through the use of unusually aggressive accounting practices.
- Nonfinancial management’s excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates.
- A practice by management of committing to analyst, creditors, and other third parties to achieve what appear to be unduly aggressive or unrealistic forecasts.
- High turnover of senior management, counsel, or board members.
- Known history of securities law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.
- Stained relationship between management and the current or predecessor auditor.

Risk Factors Relating to Industry Conditions

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Declining industry with increasing business failures.
- Rapid changes in the industry, such as significant declines in customer demand, high vulnerability to rapidly changing technology, or rapid product obsolescence.

*The risk factors are excerpted from AICPA Statement on Auditing Standards 82, “Consideration of Fraud in a Financial Statement Audit” (1997). That statement was issued to provide guidance to auditors in fulfilling their responsibility “to plan and perform the audit to obtain reasonable assurance about whether the financial

statements are free of material misstatement, whether caused by error or fraud.” Although there risk factor cover a broad range of situations, they are only examples. In the final analysis, audit committee members should use sound informed judgment when assessing the significance and relevance of fraud risk factors that may exist.

Risk Factors Relating to Operating Characteristics and Financial Stability

- Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity – including need for funds to finance major research and development or capital expenditures.
- Assets, liabilities, revenues, or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity, such as ultimate collectibility of receivables, timing of revenue recognition, reliability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Significant, unusual, or highly complex transactions close to year end and that pose difficult “substance over form” questions.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- Overly complex organizational structure involving numerous or unusual legal entities, managerial line of authority, or contractual arrangements without apparent business purpose.
- Difficulty in determine the organization or individual(s) that control(s) the entity.
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry.
- Especially high vulnerability to changes in interest rates.
- Unusually high dependence on debt or marginal ability to meet debt repayment requirements. Debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programs.
- Threat of imminent bankruptcy or foreclosure.
- Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported.
- Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.
- Inability to generate cash flows from operations while reporting earnings and earnings growth.