Appendix. Comprehensive Checklist of Warning Signs

Balance Sheet and Statement of Operations

Warning Sign	Problem Indicated or Shenanigan Used
Cash and equivalents decline relative to total assets	Liquidity issues; may need to borrow
Receivables grow substantially faster than sales	Perhaps aggressive revenue recognition-recording revenue too soon or granting extended credit terms to customers
Receivables grow substantially slower than sales	Receivables may have been reclassified as another asset category
Bad debt reserves decline relative to gross receivables	Under reserving and inflating operating income
Unbilled receivables grow faster than sales or billed receivables	A greater portion of revenue may be coming from sales under the percentage-of-completion method
Inventory grows substantially faster than sales, cost of sales, or accounts payable	Inventory may be obsolete, requiring a write-off; company may have failed to charge the cost of sales on some sales
Inventory reserves decline relative to inventory	Under reserving and inflating operating income
Prepaid expenses shoot up relative to total assets	Perhaps improperly capitalizing certain operating expenses
Other assets rise relative to total assets	Perhaps improperly capitalizing certain operating expenses
Gross plant and equipment increases sharply relative to total assets	Perhaps improperly capitalizing certain operating expenses
Gross plant and equipment declines sharply relative to total assets	Failing to invest in new plant and equipment
Accumulated depreciation declines as gross plant and equipment rises	Failing to take sufficient depreciation charge-inflating operating income
Goodwill rises sharply relative to total	Perhaps tangible assets were

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assets	reclassified to goodwill to avoid expensing them in future periods
Accumulated amortization declines as goodwill rises	Failing to take sufficient amortization charge-inflating operating income
Growth in accounts payable substantially exceeds revenue growth	Failed to pay off current debts for inventory and supplies-will require larger cash outflow in future period
Accrued expenses decline relative to total assets	Perhaps company released reserves – inflating operating income
Deferred revenue declines while revenue increases	Either new business is slowing or company released some reserves to inflate revenue
Cost of goods sold grows rapidly relative to sales	Pricing pressure results in lower gross margins
Cost of goods sold declines relative to sales	Company may have failed to transfer the entire cost of the product from inventory
Cost of goods sold fluctuates widely from quarter to quarter relative to sales	Unstable gross margin could indicate accounting irregularities
Operating expenses decline sharply relative to sales	Perhaps improperly capitalizing certain operating expenses
Operating expenses rise significantly relative to sales	Company may have become less efficient, spending more for each unit sold
Major portion of pretax income comes from one-time gains	Core business may be weakening
Interest expense rises materially relative to long-term debt	Higher cash outflow expected
Interest expense declines materially relative to long-term debt	Perhaps improperly capitalizing certain operating expenses
Amortization of software costs grows more slowly than capitalized costs	Perhaps improperly capitalizing certain operating expenses

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Statement of Cash Flows

Warning Sign	Problem Indicated or Shenanigan Used
CFFO materially lags behind net income	Quality of earnings may be suspect or expenditures for working capital may have been too high
Company fails to disclose details of cash flow from operations	Company may be trying to hide the source of the operating cash problem
Cash inflows come primarily from asset sales, borrowing, or equity offerings	Signs of weakness, especially if cash comes exclusively from asset sales, borrowing, or equity offerings

Narrative: Footnotes, Management Discussion, Proxy, and Auditor's Letter

Warning Sign	Problem Indicated or Shenanigan Used
Change in accounting principle	Attempt to hide an operating problem
Change in accounting estimate	Attempt to hide an operating problem
Change in accounting classification	Attempt to hide an operating problem
Change in auditor	Sign of risky client
Change in CFO or outside counsel	Sign of risky client
Investigation by the SEC	Could lead to accounting restatement
Long-term commitments/ contingencies	Potentially large drain on cash reserves
Current or potential litigation	Potentially large drain on cash reserves
Liberal accounting policies	Financial reports may inflate profits
Misguided management incentives	May lead to some financial shenanigans to boost profits, bonuses, and share price
Weak control environment	Creates easy opportunities to perpetrate financial shenanigans
Auditor's concern	

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Promotional management	Sign of risky client
Use of percentage of completion accounting	May be more likely to use financial shenanigans than more modest executives
Use of bill and hold accounting	Revenue may be inflated
Over reliance on a few customers	
	Revenue may be inflated
Financial problems at key customer	Potential business problem if one of them leaves
Seller finances customer	Business can be hurt if a key customer files for bankruptcy
Customer has right of return	Revenue may be inflated and business may be much weaker than you realized
Barter transaction	
Seller gives customer stock warrants	Revenue may have been recorded too soon
Capitalized interest or software	
	Revenue may have been inflated
Unrecorded liabilities, such as stock options	Revenue may have been inflated
	Operating income may be inflated
Noncompliance with debt covenant	Future cash obligations may be greater than expected and operating income may be inflated
Absence of unaffiliated directors on board	
	Bank may call loan, causing a substantial cash crunch
Prepayment of future period’s operating expenses	Weak control environment may create opportunities for management to perpetrate financial shenanigans
	Leads to inflated operating income in future periods

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Checklist 1: Possible Signs of Misleading Financial Statements

Choosing accounting policies	Too liberal
Changing accounting policies	Unjustified
Deferring expenses	Profits are overstated
Income smoothing	Profits are understated
Recognizing revenue too soon	Profits are overstated
Under accruing expenses	Profits are overstated
Changing discretionary costs	Manipulating profits
Low quality controls	Risk of shenanigans
Changing auditor	Risk of shenanigans
Taking a "big bath"	Future profits are boosted

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