

CFA LEARNING OUTCOMES DECODED

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. This article is written by Mark St. Marie, CFA. Mark has extensive experience working both as an equity analyst on the sell side and as an equity analyst, trader, and portfolio manager on the buy side.

FINANCIAL STATEMENT ANALYSIS: FINANCIAL REPORTING QUALITY

LOS: Describe accounting warning signs and methods for detecting manipulation of information in financial reports

This LOS highlights the importance of an analyst's role in determining discrepancies, misrepresentations, and other forms of attempted manipulation of a company's financial statements. Understanding it requires extensive knowledge of the major financial statements and their footnotes. However, learning the basics of manipulation techniques in this LOS should enable students to answer items related to this topic on the Level I exam.

Revenue recognition warning signs

- Large, unusual, or unexpected one-time increases or decreases in revenue, especially non-operating
- Changes in revenue recognition methodology (% completion, etc.), or practices that are not fully disclosed or explained
- Unusually high revenue and/or profit growth vs. competitors that operate in the same business
- Changes in rebate estimates, especially decreases in rebates
- Increase in days of sales outstanding (DSO) at the same time as a decrease in total asset turnover could imply sales were jammed into the end of a reporting period and have yet to be collected.

Inventory warning signs

- Increase in days of inventory held (DIH)—This may mean the company is overproducing and/or taking longer to sell its products
- Decreasing inventory, lower COGS and higher earnings—together suggesting LIFO liquidation

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Cash flow and capitalization warning signs

- Operating cash flow to net income ratio of <1 and/or decreasing could indicate inability to collect receivables, unusually high depreciation, and/or increasing cash SG&A expenses vs. revenues

Other warning signs

- Unusual or unexpected increases in net income or cash flow, especially if accompanied by a decline in revenue
- Failure to follow GAAP or IFRS, or present financials without proper or sufficient disclosures
- Overemphasis on non-GAAP reporting measures
- Frequent earnings surprises
- Frequent acquisitions, especially if unrelated to company's primary business
- Frequent transactions with related parties such as subsidiaries/affiliates, the company's pension and profit-sharing trusts, and/or the immediate family members of officers or management

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PRACTICE QUESTION

Which of the following actions would *most likely* be considered an attempt to manipulate a company's financial statements?

- A. A toy manufacturer offers increased sales promotions to its retail distributors on several of its products that will be phased out over the coming year.
- B. An auto manufacturer offers large incentive bonuses to its sales staff in the final two weeks of some quarters to enable the company to meet its stated unit sales and revenue goals but does not increase production of the vehicles.
- C. A company presents its financials according to GAAP but routinely provides supplemental earnings calculations that exclude currency effects and one-time charges/credits.

B is correct. Management is attempting to “stuff the quarter” by incentivizing its sales staff to sell more vehicles than would have been sold under normal circumstances, especially since the company has not increased production. This is an attempt to artificially inflate revenue to meet its objectives. This would be an acceptable practice if the incentives were offered in *every* quarter. However, they are offered only in those quarters in which unit sales and revenue figures could potentially miss its stated targets.

Answer A is incorrect. The toy manufacturer is simply attempting to clear out inventory of products that will be phased out over the coming year. This is a routine and acceptable business practice.

Answer C is incorrect. Many companies routinely provide supplemental earnings calculations that allow (what the company considers to be) a more equitable basis for comparison of its current net income to other quarters, to its competitors, and, if applicable, to its stated earnings guidance/objectives. It is up to the analyst to determine which (if any) of the line items included in the supplemental calculations should be included (or excluded) in the company's calculation of net income.