Red Flags in Financial Analysis

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Red Flags in Financial Analysis

Meaning

A red flag is a warning for any analyst or investor indicating some potential problem with a company's in financial report of the company.

How to Identify Red Flags?

There is no universal standard for identifying red flags. The method used to detect problems with an investment opportunity depends on the research methodology an investor, analyst, or economist employs. This may include examining financial statements, economic indicators, or historical data. Investors need to exercise *due diligence* when considering for taking investment decision with the company.

What Is Due Diligence and How to Do it?

Due diligence is an investigation, audit or review of financial records to confirm the facts of a matter under consideration before entering into a proposed transaction with another party.

Important Steps for Due Diligence by Investors:

1. Analysis of Capitalization of the company
2. Look at trends in revenues, operating expenses, EBIT, EBT, EAT, ROI and ROE
3. Comparison with Competitors and Industrial Position
4. Analysis of Price Earning (P/E) and Price to Sales (P/S) Ratios
5. Board of Directors, managers and share ownership pattern in the company
6. Analysis of Consolidated Balance Sheet of the Company
7. Stock Price Movements trends in short and long run
8. Stock Dilution Possibilities
9. Expectations of Stakeholders
10. Company and industry related risk factors

Some Easily Identifiable Red Flags

1. Increasing Debt Equity Ratio
2. Consistently Decreasing Revenues
3. Fluctuating Cash Flows
4. Undesirable Fluctuations in the Market Price of Shares
5. A pending law suit against the company

Different Levels of Red Flags

1. Economic Red Flags
2. Industry level Red Flags
3. Corporate Red Flags
4. Red Flags in Financial Statements

Some Important Red Flags

1. Too Good to be True
2. Auditors vs. Management
3. Accounting Policies
4. Changes in accounts and management
5. Anomalies
6. Complexity of transactions
7. Bonuses and performance
8. Increasing gross profit margin
9. Debt covenants
10. Rising inventory and debtors in relation to sales

Some important red flags…cont.

Too good to be true

When financial results are over attractive, you should not accept them immediately. You are required to make a deep investigation and see whether these results are consistent for a long period or are over nightly shown.

Auditors vs. Management

During every audit, auditors track and list all errors they find. This is often called a 'Summary of Misstatements' and is included in the Auditors Report to Management. This summary is of great help for analyst.

On the other hand, management can have a difference of opinion to their auditors when it comes to financial reporting, often reluctant to recognize fully or early potential losses, whereas auditors generally take a more conservative approach.

The analyst has to compare view and reports of both the auditors and management in order to track the red flags.

Accounting policies

Unusual accounting policies, practices and methods can sometimes point to misstatement and make it difficult to compare performance to similar businesses.

These unusual accounting policies may be relating to:

1. Over or under estimation of assets with the help of depreciation policies
2. Inventory valuation
3. Creation of reserves
4. Treatment Research and Development Expenses
5. Managing profits through non operating activities
6. These unusual accounting policies result in very different Earnings before Interest Tax Depreciation and Amortization (EBITDA) and Net Profit before Tax (EBT)

Changes in accounts and management

Changes to an entity and to its financial reporting can come in many forms, for example:

1. Trends in the balance sheet and P&L ratios (e.g. debt to equity ratio or working capital turnover ratio can point to worsening operating conditions).
2. Large late adjustments to accounts due to errors or inaccurate data.
3. Change in Senior Management which could mean a change in management style and internal culture.

The analyst should see the impact of all such changes on the quality of reporting.

Anomalies

An anomaly in the financials, where numbers are higher or lower than what would normally be expected should be investigated.

There are a number of common anomalies that serve as a red flag and require further inspection such as:

1. If the Other Expenses category of the Profit and Loss Statement is very high it should alert you to a potential problem. *Abnormally large legal fees* or management trying to hide *excessive travel expenses* are commonly found to be concealed in this category.
2. A very high proportion of monthly or quarterly sales in last few days of a period may indicate an anomaly.
3. A build-up in the value of work-in-progress, fixed assets or intangibles above expectations may be signs that operating costs are being capitalized, instead of being expensed through the Profit and Loss Statement.

Complexity of Transactions

Complex transactions, both internal and with third-parties, that are not well understood or do not appear to have sound economic basis should be regarded with caution. For example, Enron used limited liability special purpose entities to transfer liability from its own accounts. In many other cases, similar complex structure transactions can be misused in order to deceive.

Bonuses based on Performance

When management compensation is tied closely to performance and bonuses, there is a greater incentive for those in charge to manipulate the financial results. In addition, an over-emphasis on short-term performance in relation to awarding bonuses could also lead to managerial decisions that are not in the best interest of the entity in long-term.

Increasing gross profit margin

An increasing Gross Profit % may not always be a good sign, particularly when overheads are more than outpacing it or sales are declining, as this eventually leads to a net loss. Gross Profit Margin should not be looked at in isolation but viewed together with sales levels and overheads.

Debt covenants

Where an entity is on the verge of breaching a debt covenant and the loss of a credit facility is looming overhead, there is a huge temptation for management to misstate the accounts or the calculation of the covenant leverage ratios in order to avoid the severe repercussions.

In order to check the potential such impending problems, obtain more detail on the covenants themselves and the level of safety margin.

Rising inventory or debtors in relation to sales

Rising inventory or debtors can be a sign that future stock write-downs are to follow or that there are impending bad debts. Analysis of debtors and inventory should be done to understand the drivers of these increases, and also what can be done to mitigate any negative outcomes.

Concluding Remarks

1. Red Flags are the possible threats or problems which may be hidden in the financial report of the company. Although it is hard to detect them but with rules of thumb a common analyst can detect them and can safeguard itself.
2. An analyst can take the help of due diligence in order the check that things are normal in the reported company and if there is any red flag it can be detected through it.
3. Some important aspects of due diligence are to analyze company capitalization, revenue-expense trends, competitive ranking of company, to know about promoters/Board of Directors track record, financial statements, expectation of stock holders.
4. Different levels of red flags are economic, industrial, company specific and financial statement related.
5. The important red flags are relating to complicated transactions, anomalies, accounting policies, debts covenants, stock dilution and expectations of stakeholders.
6. Detection of red flags safeguards the stakeholders from taking wrong financial decisions.