# Chapter 14

# Identify Yellow Flags through Forensic Accounting

## Introduction

In a perfect world, equity analysts would be omnisciently aware of every aspect of a company's inner workings, including the level of conservatism or aggressiveness in its treatment of accounting issues. As much as the general media expects us to see through walls and use our clairvoyance to read management's minds, this is beyond the ability of most equity analysts. Very often, when financial fraud occurs, the company has fooled even its own auditors, but this gets lost on the press, which point the blame at Wall Street analysts for missing the problem.

This isn't to say that analysts should just ignore accounting, but rather they should set expectations for what it is: an opportunity to see early warning signs that problems are developing; I like to call them *yellow flags*. I had a low-profile find when I published a report questioning the accounting behind an abnormally low tax rate for one of my companies, suggesting that it was unlikely to be sustainable. (A few years later, the company took a substantial charge because it deemed the tax rate had been set artificially too low.)

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Discovering these problems can require plenty of time and in some cases, specialized resources. At Morgan Stanley, we had a Global Valuation and Accounting Team (GVAT) that had a staff of former and existing university professors and a few other senior team members who specialized in finding these accounting problems. If you don't have in-house resources dedicated to helping spot accounting anomalies, there are a few other options:

- Develop a discipline in your financial analysis to spot yellow flags.
- Hire a firm that specializes in spotting accounting problems.
- Accept the fact that you're not likely to spot these.

I don't advocate the last option, but sadly it's the course many analysts take.

Spotting yellow flags requires that the analyst understand the underlying economic transactions that generate each important financial statement item. If you don't know how a particular item is generated and measured, find out. Understanding how values are measured using the applicable accounting rules will enable you to identify items where management can take advantage of flexibility in accounting rules to achieve its financial reporting objectives. Ask questions and be relentless. Do not give up until you understand enough to determine the likelihood that the item is materially misstated. Adjust any materially misstated values before using them for analysis. This step is critical to avoid inaccurate valuations and incorrect inferences. Beyond the best practices discussed here, one of the best resources on this topic is the book *Financial Shenanigans* by Howard Schilit and Jeremy Perler, now in its third edition. Furthermore, market data service providers have tools that can speed up the assessment of a company's financial data (StarMine Professional provides an "earnings quality" rank for most companies including over a dozen financial metrics in this area).

# BEST PRACTICES FOR EQUITY RESEARCH ANALYSTS

ESSENTIALS FOR BUY-SIDE AND SELL-SIDE ANALYSTS


Identifying Factors That Drive the Stock

Creating Financial Forecasts

Mastering the Practical Valuation Tools

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