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Identifying Major Red Flags in the Income Statement

- Overstating Revenue: Pulling future revenue back to the current period has effect of inflating current period earnings and reducing future period earnings. Read the financial statement footnotes to understand how a company recognizes revenue and compare it with its peers as well as practices of the past. The most common areas are ;
  A) Prematurely reporting revenue (such as when the customer's orders are received rather than when the product is shipped)
  B) Reporting too high of an estimate when revenue is estimated such as long term contracts that are based on estimates of the percent of work completed)

- Understated expenses: Pushing current expenses into future periods, such as delaying or understating an expense, has the effect of overstating current period earnings.

- Capitalizing costs that should be expensed or spreading costs recognition over an unrealistically longer time period reduces its near term impact by understating expenses, and thus inflating current earnings. The latter abuse can include any time of depreciation or amortization expense, because management often has discretion estimating the useful life and salvage values.

- Pension expenses can be manipulated by certain assumptions. Analyze changes in the pension assumptions over time to ensure that they are consistent with the market trends and that none of the company's assumptions are substantially different from it competitors. Key assumptions that can be manipulated include the following:
  A) Raising the discount rate causes pension expense to decrease.
  B) Raising the estimated return on plan assets lowers pension expense.

- Special charges should be scrutinized because management often has discretion, which facilitates earnings management. Overstating some current charges can reduce future expenses and thus artificially inflate future earnings. Special chargers can come in the form of:
  A) Restructuring (due to change in company strategy)
  B) Mergers & Actuations (due to onetime costs associated with these activities)

- Non-operating income such as an asset sale: It's the small sale that can have the most benefit to a company, because they often don't get identified by analysts as a special item. When they are large enough to significantly distort earnings, management usually makes a point of highlighting the sale, which then gets removed by most sell-side and buy-side analysts as non-recurring. Identify the line item where companies bury their gain on sales and routinely watch for that line item to fluctuate.

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