Checklists for Evaluating Quality of Earnings

Checklist for Overstated Assets

1) **Is the allowance for doubtful accounts sufficient to cover future collection problems?**
   a) Compute DSO for each of the last four to six quarters
      i) Is the trend steady, improving, or worsening?
      ii) Is the overall level high when compared with competitors in the industry?
   b) What amount of accounts receivable are at risk for a write-down?
      i) By what amount would the allowance for doubtful accounts need to be increased, reducing net accounts receivable, such that DSO would be more in line with a target based on prior years, competitors, or the industry?
         (1) Calculate as target DSO reduction multiplied by revenue per day

2) **Have economic conditions for the company's customers worsened recently?**
   a) Are company sales declining?
   b) Are there other general economic reasons to expect that customers are, or may be, having difficulties?

3) **Are sales growing rapidly?**
   a) Has the company changed its credit policy?
      i) Is credit being granted to less creditworthy customers?
   b) Have payment terms been extended?

4) **Are inventories overstated because of inclusion of nonexistent inventories or by the reporting of true quantities on hand at amounts that exceed replacement cost?**
   a) Compute gross margin and inventory days for the last four to six quarters
      i) Is the trend steady, worsening, or improving?
      ii) How do the statistics compare with competitors in the industry?
         (1) Before making comparisons with competitors, make sure that the same inventory methods (LIFO, FIFO, etc.) are being used
   b) Do ongoing company events and fortunes suggest problems with slackening demand for the company's products?
      i) Are sales declining?
      ii) Have raw materials inventories declined markedly as a percentage of total inventory?
   c) Are prices falling, suggesting general industry weakness and an increased chance that inventory cost may not be recoverable?
   d) Is the company in an industry that is experiencing rapid technological change, increasing the risk of inventory obsolescence?

- e) Has the company shown evidence in the past of inventory overvaluation?
  - i) Is there an example of a prior year write down of inventory that became value impaired?
- f) Does the company use the FIFO method?
  - i) Companies that use FIFO run a greater risk that inventory costs may exceed replacement costs

5) Does the company employ the LIFO inventory method for at least a portion of its inventory?

- a) Are LIFO adjustments being made for interim periods?
  - i) Has the LIFO reserve account remained unchanged during interim periods?
  - ii) If the LIFO reserve account has been adjusted during interim periods, does the estimate of inflation used appear reasonable?
  - iii) How does gross margin for interim periods compare with prior years' annual results?
  - iv) Do increased gross margins suggest the influence of undisclosed LIFO liquidations?

6) What is the nature of the company's environment with respect to inventory controls?

- a) Do controls to guard against theft seem adequate?
- b) When a physical inventory is taken, how does the amount compare with the books?
  - i) Do the books consistently exceed the physical count by a significant amount>
  - ii) Are the books adjusted, or are differences dismissed as errors in taking the physical inventory?

7) For debt securities held until maturity, and non-marketable equity securities:

- a) Is there evidence of a non-temporary decline in market values?

8) For debt securities and marketable equity securities that are available for sale:

- a) Are investment losses included in shareholders' equity that might be taken to income?
  - i) Might the designation of these losses be changed to other than temporary?
  - ii) Is sale of one or more investments imminent?
- b) Has shareholders' equity been buoyed by substantial write-ups to market value?

9) For investments accounted for under the equity method:

- a) Is there evidence of a non-temporary decline in market value?

Checklist for Understated Liabilities

1) **Are coupon or stated interest rates on long-term notes and bonds payable significantly higher than the current level of rates?**

2) **What are the prospects for early retirement of this debt leading to an associated extraordinary loss**

3) **Accrued expenses payable**
   a) What is the trend in accrued expenses payable?
   b) Does an improvement in selling, general, and administrative expenses as a percentage of sale revenue reflect true operating efficiencies?

4) **Accounts payable**
   a) Compute accounts payable in days for each of the last four to six quarters
      i) Is the trend steady, worsening, or improving?
      ii) How does the statistic compare with competitors' in the industry?
   b) How does the percent change in accounts payable compare with the percent change in inventory?

5) **Contingent liabilities**
   a) What unrecognized contingencies are noted in a careful reading of the footnotes?
   b) Given an understanding of the company's business dealings, is there reason to believe that an unrecognized contingent liability exists?
   c) Does the company have speculative investment positions?
      i) Is the risk of loss limited to an amount reported on the balance sheet?
      ii) Is the risk of loss reported off the balance sheet in the footnotes?
   d) Special questions related to financial derivatives
      i) Why has the firm taken the position?
         (1) Is it a hedge or a speculation?
         (2) Does it make sense for the company to be taking positions in financial derivatives?
      ii) Does management have the expertise to properly take the positions taken?
      iii) What is the off-balance-sheet exposure to loss?
         (1) What would happen to assets and shareholders' equity if the total exposure to loss were to be realized?

Checklist for Overstated Revenue

1) What is the company's revenue recognition policy?

a) Before delivery or performance?
   i) Is it really earned?
b) At delivery or performance?
   i) Is there a right of return or price protection?
      (1) Has the company provided adequately for returns or price adjustments?
   ii) Does the company offer separate letters offering the right of return or price protection not contained in the actual sale contract?
c) After delivery or performance and full customer acceptance?

2) Was there a change in the revenue recognition policy?

a) Did the change result in early revenue recognition?

3) Are there any unusual changes in revenue reported in recent quarters?

a) What is revenue for each of the last four to six quarters?
b) Does any one quarter show unusual activity not explained by seasonal factors?
c) How do quarterly changes in revenue compare with the industry or selected competitors?

4) Does the company have the physical capacity to generate the revenue reported?

a) What is revenue per appropriate measure of physical capacity for each of the last four to six quarters?
b) How does the company compare with the industry or with selected competitors?
   i) Possible measures of revenue per physical capacity:
      (1) Revenue per employee
      (2) Revenue per dollar of fixed assets
      (3) Revenue per dollar of total assets

5) Are there signs of overstated accounts receivable?

a) Compare the percentage rate of change in accounts receivable with the percentage rate of change in revenue for each of the last four to six quarters.
   i) What are the implications of differences in the rates of change in accounts receivable and revenues?
b) Compute accounts receivable DSO for each of the last four to six quarters
   i) What are the implications of changes noted in DSO and changes therein compared with the industry and selected competitors?

6) Does the company use the percentage-of-completion method for long-term contracts?

a) Is management experienced in applying the methods?

b) Has the company reported losses in prior years from cost overruns?

c) Depending on data availability, compute unbilled receivables as a percentage of cumulative contract revenue for each of the last four to six quarters.

   i) What are the implications of the percentage and its trend?

d) Compare the percentage rate of change in unbilled receivables with the percentage rate of change in contract revenue for each of the last four to six quarters.

   i) What are the implications of differences between the rates of change in unbilled receivables and contract revenue?

Checklist for Understated Expenses

1) For cost capitalization generally

a) What are the company's policies with respect to cost capitalization?
   i) Is the company capitalizing cost that its competitors expense?
   ii) Does the company expense more, taking a more conservative approach?
   iii) What do capitalized costs represent?
      (1) An identifiable asset with an ascertainable market value?
      (2) Not an identifiable asset, whose market value, if any, is tied to the general fortunes of the company?

b) Do capitalized costs exceed net realizable value?

2) For companies incurring software development costs

a) What proportion of software development costs incurred is being capitalized?
b) How does this percentage compare with competitors or other companies in the industry?

3) For companies capitalizing interest costs

a) Should capitalization of interest costs be discounted?
   i) Is the asset under construction complete and available for its intended use?
   ii) Do costs incurred on the asset under construction give an indication of exceeding net realizable value?
      (1) Have there been construction delays?
      (2) Have there been cost overruns?

4) For companies incurring oil and gas exploration expenditures

a) Does the company use the successful-efforts method (expensing option) or the full-cost method (capitalization option) to account for exploration expenditures?
b) Do costs capitalized appear to be realizable?

5) A policy of capitalizing the following costs should be considered very aggressive, potentially at odds with generally accepted accounting principles:

   i) Advertising, marketing, and promotion costs
   ii) Costs incurred to acquire new members or subscribers unless costs can be linked with new sign-ups
   iii) Costs incurred on internally conducted research and development activities (software development excluded; can be capitalized after technological feasibility has been reached)

6) Has the company shown evidence in the past of being aggressive in its capitalization policies?

a) Is there an example of a prior-year write-down of capitalized costs that, in hindsight, should not have bee capitalized?

7) Has the company selected extended amortization and depreciation periods for capitalized costs?

a) As data permit, how does the calculated average amortization period for long-lived assets compare with competitors or other firms in the industry?
   i) Calculated as average asset costs, excluding land and construction-in-process, divided by the annual amount of depreciation or amortization expense
   ii) Can be calculated for property, plant, and equipment accounts and other capitalized costs, including technology-related assets like software development costs.

8) Be particularly alert for extended amortization periods in the following situations:

a) Company's industry is experiencing price deflation
b) Company in an industry that is experiencing rapid technological change
c) Company has shown evidence in the past of employing extended amortization periods
   i) Is there an example of a prior-year write-down of assets that became value impaired?