The opinion of investors and lenders on red flags
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The opinion of investors and lenders on red flags

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There is increasing international concern about the escalation in fraudulent financial statement reporting and the difficulties in detecting and proving such fraud.

In the United States, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) was appointed to identify causal factors that lead to fraudulent financial reporting and on the steps that would reduce such incidents. The Treadway Commission (1987) suggested that the damage resulting from fraudulent financial reporting is widespread with a devastating ripple effect. Victims range from the immediate (shareholders and creditors) to the more remote (investor confidence in stock markets and the credibility of the audit profession).

A major obstacle to addressing the problem of financial statement fraud promptly, is related to the difficulty of identifying the fraud soon after its occurrence. Because it is often a management fraud, it is well hidden from auditors, investors and other stakeholders and it is usually only discovered by chance or once the company is in financial difficulty, which may result in a takeover or insolvency. It is therefore important to attempt to manage the risk of fraud by using early warning signals such as 'red flags'.

Red flags

Red flags are events, conditions, situational pressures, opportunities or personal characteristics that may cause management to commit fraud on behalf of the company or for personal gain. They can be used as an early warning system by both auditors and other stakeholders to assess the risk of financial statement fraud. Although red flags may not necessarily indicate the presence of fraud, they are conditions believed to be commonly present in the event of fraudulent activities and may therefore warrant concern.

In the past red flags have been addressed from the perspective of the auditors of enterprises. The problem is that the red flags identified by the auditing profession are not necessarily relevant to lenders and investors. Lenders and investors require red flags that are appropriate to their particular interests and their access to information on the enterprise and its management. It is also investors and lenders who may take legal action against auditors and management based on their perception of negligence in respect of financial statement fraud. Therefore, it is important that auditors and management should take cognisance of the opinion of lenders and investors concerning red flags.

The survey

A questionnaire was developed to survey the opinions of investors and lenders in South Africa regarding red flags. It was sent to a selected sample of investors and lenders. The survey addresses the use of red flags by lenders and investors, their opinion on the relative importance of individual red flags as well as the identification of additional red flags.

It is assumed in the survey that the banks are representative of the lending institutions while the portfolio managers are representative of the investing community in South Africa. A list of domestic and international banks registered with the Registrar of Banks was obtained. Questionnaires were sent to the Chief Executive Officers of the local banks and branches of international banks with the request to hand these to officials responsible for lending decisions in their institutions.

A list of portfolio managers registered with the Financial Services Board was obtained and only one questionnaire was sent to each member. The registered portfolio managers ranged from major financial institutions to small businesses, and the questionnaire was sent to the contact person noted on the list.

The questionnaire was derived from the red flags identified in the research of Albrecht and Romeny (1986), and from the South African auditing standards SAAS 240 (SAICA 1997) and ED 137 (SAICA 2000). These red flags were, however, developed for use by auditors. Consequently, the researchers screened the red flags and eliminated those where the information would normally only be available to auditors. Any red flags that were duplicated were also omitted. No new or additional red flags were added to the questionnaire, but the surveyed target group was asked to identify additional red flags.

The nature of red flags in the questionnaire tended to be subjective and therefore the purpose of the survey was to obtain the opinions of investors and lenders concerning the relative importance of these red flags to them. In total 65 red flags were identified in the questionnaire. A scale was used to measure the perceived importance of these red flags ranging from negligible (1) to important (5). The questionnaire also asked participants in the survey to indicate whether they were familiar with the concept of red flags, had previously used red flags in decision making, had used formalized checklists on red flags and whether they believed such checklists could be useful.

Results

Although the response to the survey was disappointing, 46 questionnaires were returned, of which 29 were from lenders and 17 from investors. Of the responses received to the survey 28 (60,9%) were familiar with the term red flags while 16 (34,8%) were not (two respondents (4,3%) gave no response). Of the respondents that were familiar with the term red flags, 22 (78,6%) had previously used red flags in decision making, while the other six had not.

With regard to the respondents (22) that had used red flags in decision-making, 7 had used formalized questionnaires and checklists while 15 had not. It would therefore appear that the use of formalized questionnaires and checklists in South Africa is fairly limited. In response to the question whether the use of questionnaires and ▶22

checklists may be helpful in assessing the risk of fraud in financial statements 36 (78%) of the respondents agreed. The same respondents also indicated that such questionnaires and checklists may also be helpful in collecting relevant information.

Both lenders and investors identified the red flag "dishonest or unethical management" as the most important. However, they did not rank the same red flags as least important, although there were commonalities with respect to the three least important red flags. What is interesting about the three least important red flags is that they are all related to the operating characteristics of the business. The most important red flags focused on management characteristics and influence over the control environment. This seems to support prior research that the best predictive red flags are those on the attitudes and situational pressures on management. A statistical analysis of the results (Mann-Whitney test) indicated however, that respondents did not necessarily attach more importance to this latter category.

Respondents were also asked to identify any additional red flags not specifically covered by the questionnaire. The following were suggested:

- Merger and de-merger of group companies.
- Significant presence of financial executives at top management.
- A change in financial year-ends (making accounting results incomparable).
- Size of the auditing firm in relation to the client.
- Limited management oversight on remote operations.
- Unskilled, inexperienced executives pushed into positions prematurely.
- Frequent corporate restructuring.
- Significant changes in the structure of the income, fees, interest.
- Good news too good to be true.
- Wide fluctuations in financial ratios from year to year.
- Share options being re-priced.

Summary

The aim of the survey is to consider the importance of red flags to lenders and investors in South Africa. An approach to red flags from the perspective of lenders and investors is a relatively under-researched area if compared to what was done from an auditor's perspective. It is however, important that auditors and managers take cognisance of the opinion of lenders and investors concerning red flags as reflected in this research. Negative perceptions of lenders and investors resulting from red flags can be reflected in a weaker share price, difficulties in obtaining funding and in the off loading of shares.

The lenders and investors identified the following red flags as the ten most

Rank	Lenders	Investors
1.	Dishonest or unethical management.	Dishonest or unethical management.
2.	There are frequent changes of legal counsel, auditors or external board members.	There has been a breakdown in accounting and control systems as reflected by the late issuing of financial statements or a qualified report.
3.	Management is dominated by one person (or a small group) and there is no effective oversight board or committee.	Suspension or de-listing from stock exchange.
4.	Suspension or de-listing from stock exchange.	Management's reputation in the business community is poor.
5.	Inability to generate cash flows from operations while reporting earnings and earnings growth.	Management is dominated by one person (or a small group) and there is no effective oversight board or committee
6.	Continuous problems with regulatory agencies.	There are frequent changes of legal counsel, auditors or external board members.
7.	There is a high turnover rate of key top management specifically financial executives.	Internal or external factors exist that raise substantial doubt about the entity's ability to continue as a going concern
8.	Internal or external factors exist that raise substantial doubt about the entity's ability to continue as a going concern.	Continuous problems with regulatory agencies.
9.	Management's reputation in the business community is poor.	Identification of important matters not previously disclosed by management.
10.	Reluctance to provide investors/bankers with needed data.	Inability to generate cash flows from operations while reporting earnings and earnings growth.

The lenders and investors identified the following red flags as the ten least

Rank	Lenders	Investors
1.	Pressure is exerted on accounting personnel to complete financial statements in an unusually short time period as reflected by approval date of financial statements.	Rapid expansion into new product lines.
2.	Unusually long business cycle.	Pressure is exerted on accounting personnel to complete financial statements in an unusually short time period as reflected by approval date of financial statements.
3.	Rapid expansion into new product lines.	Unusually long business cycle.
4.	Limited collateral available.	Key executives feeling undue family, peer, or community pressure to succeed.
5.	The entity has a significant investment in an industry or product line noted for rapid change.	Key executives with perceived inadequate incomes relative to industry.
6.	Poor interpersonal relationships among executives.	Adverse political, social, or environmental impact.
7.	The entity is heavily dependent on one or a few products, customers or suppliers.	Insufficient internal audit personnel.
8.	Declining demand for products.	The entity has a significant investment in an industry or product line noted for rapid change.
9.	Key executives feeling undue family, peer, or community pressure to succeed.	Limited collateral available.
10.	Adverse political, social, or environmental impact.	Failure to inform investors about code of conduct and good corporate governance.

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The following are apparent from the survey:

- Lenders and investors in South Africa were in the majority of instances aware of red flags;
- Respondents did not tend to use formalized methods such as red flag checklists / questionnaires;
- Lenders and investors rated the red flags as being very important;
- No clear statistical distinction was discernable in the relative importance of different categories of red flags, such as management characteristics, operational stability, and financial stability and industry conditions; and
- Both investors and lenders indicated that dishonest or unethical management was the singularly most important red flag indicator.

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