



This is “Appendix B: Red Flags in Management”, appendix 2 from the book [Governing Corporations \(index.html\)](#) (v. 1.0).

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Chapter 13

Appendix B: Red Flags in Management

Analysis of corporations that have experienced major ethical and financial difficulties shows these companies have a great deal in common in terms of their corporate culture and management profiles, as well as their accounting and governance practices. On the basis of this knowledge, we can identify a number of early warning signals, or red flags, boards can use to spot the emergence of a corporate environment and culture susceptible to conflicts of interest and management abuse. This appendix is from Wood (2005).

Individually, these factors may not be predictive of future problems. In groups, however, they define a heightened risk profile and should be cause for additional scrutiny and objective analysis. For example, the combination of aggressive management practices creating rapid short-term revenue and stock price growth, coupled with weak board oversight, allowing the CEO to rapidly accumulate personal wealth through stock-based incentive compensation, has been present in a significant percentage of recent problem situations. Risk of rapid financial deterioration in such cases is exacerbated when the company also operates with aggressive financial practices and high leverage.

Specifically, audit committees would be well advised to monitor the following categories of higher risk characteristics based on their proven usefulness in identifying corporate environments that may be susceptible to rapid stock price and credit deterioration, as well as fraud:

- *Business Growth Strategy and Record*
 - Aggressive pursuit of growth through acquisitions or through rapid expansion into new business lines, industries, or markets
 - Major or frequent shifts or U-turns in business or operational strategy, including history of restructuring or sale of core business units or assets
 - History of setting business growth targets, strategies, and projections that appear aggressive or overly optimistic, especially in comparison to peers
 - Growth materially in excess of peers or broader market
- *Equity Culture: Stock Price Appreciation Strategy and Management Ownership*

- Aggressive positioning as a “growth stock”
 - Overpreoccupation of management on short-term stock-price appreciation
 - Low or no common dividend policy
 - Rapid accumulation of ownership (stock and options) by senior management, at a rate and to levels materially in excess of peer group
 - Long-established CEO and senior management team with significant ownership interest where structural complexity, leverage, or opaqueness are present
 - Growth in price-earnings ratio, stock price, or market capitalization materially in excess of peers
- *Senior Management Character, Compensation, Composition, Tenure, Turnover, and Succession*
 - Cult of a CEO (leader) personality or the high media profile of CEO
 - Over-reliance on, excessive power of, or domination by the CEO, including unwillingness to delegate
 - Heavy dependence on the CEO for corporate public, client, and government relations (e.g., when the CEO is the sole or main spokesperson)
 - Weak or “domineered” senior management team below the CEO
 - CEO incentive and/or total compensation materially higher than peer average
 - Link between company financial performance and executive compensation primarily focused on short-term horizon
 - Special payments or unusual fringe benefits or loans to executives without a clear purpose, or unconnected with any increase in performance (including “guaranteed” bonuses)
 - Compensation plans or provisions that create perverse incentives (i.e., payouts that encourage excessive acquisition activity; payouts on reaching a certain share price trading level).
 - Unclear succession plan and/or failure to name a successor
 - High or unexpected senior management or board of director turnover or departures.
 - Lack of credibility in company explanation of senior departure(s)
 - Lavish CEO and senior executive lifestyle and corporate entertainment
 - *Corporate Culture and Business Practices*
 - Lack of meaningful long-term corporate planning and focus

- Creation of a “culture of greed” and management self-enrichment: materially more generous compensation pattern for the CEO and senior executives than peers
- “Make the numbers!” corporate culture: untoward pressure on managers to achieve aggressive budgets
- Creation of a “culture of fear,” penalizing internal debate and independent or creative thinking; creation of environment where only “good news” is acceptable to corporate chieftains
- “Take no prisoners!” corporate culture: questionable or heavy-handed strategies and tactics with competitors, customers, employees, suppliers, accountants, bankers, business partners, and regulators or government authorities
- History of litigation in pursuit of business strategies and undue pressure on critics (e.g., lawsuits by company against company customers, employees, suppliers, accountants, bankers, regulators or government entities)
- Lack of transparency: history of lack of openness with external and internal constituencies, including independent directors
- Heavy use of lobbyists and lawyers
- Aggressive corporate communication and image building; heavy use of “spin”
- History of aggressive or questionable sales and/or marketing practices
- Cavalier attitudes toward internal control
- *Company’s Legal, Business, Financial, Ownership, and Tax Practices*
 - Major changes in ownership, managerial, legal, regulatory, and operating structure
 - Overfocus of management time and resources on creating complex corporate legal entity, operating, finance, and tax structures (particularly if this is accompanied by intercompany asset sales, transfers, or fee payments)
 - Existence of seemingly excessive number of corporate legal entity vehicles (particularly those with limited or no clear operational mandates)
 - Heavy reliance on tax shelters or similar devices to maintain or maximize profitability
 - Management inability or unwillingness to explain reasons behind corporate-, finance-, tax-, or ownership-structure complexities
 - Aggressiveness or complexity in financial leverage and structure, including
 - high degree of leverage versus peers;

- stability of capital structure susceptible to refinancing risk;
 - over-reliance on short-term debt;
 - management inability to explain rationale for capitalization structure and financing sources and uses;
 - complexity or untoward number of financing subsidiaries or other financing vehicles within the corporate structure;
 - Overly structured financing arrangements.
- Financial stability and liquidity sensitive to triggers, contingents, or access to nonoperating sources of cash, including
 - existence of material triggers in debt, derivative and operating agreements calling for repayment or collateralization of debt or contingents given certain predefined events;
 - lack of credible contingency funding plan;
 - over-reliance on receivables sales and factoring;
 - danger of tripping covenant thresholds;
 - access or ability to borrow curtailed, increased cost of borrowing;
 - financial viability (debt service or access to capital) dependent on assets sales, extraordinary contingent realizations, or unusually large cash reserves (at borrower or subsidiaries).
- *Accounting, Disclosure Practices, and Reported Results*
 - Aggressive strategy or history of revenue or income recognition and understating costs or liabilities, including
 - net income growth materially higher than recurring cash flow growth;
 - revenue, income growth, or both, materially higher than peers;
 - aggressive use of “pro-forma” adjustments;
 - litigation or regulatory action charging illicit financial reporting practices;
 - history of understating costs or liabilities or overstating revenue;
 - history of restatements, accounting errors and irregularities, and nonrecurring and special charges;
 - large percentage of revenues and net income from nonoperating, nonrecurring sources, or both;
 - Use of aggressive accounting elections or assumptions.
 - Aggressiveness, problems, frequent changes, and complexity in accounting practices and reporting, including

- frequent changes in accounting elections and treatments, especially those affecting revenue, cost, and liability reporting;
 - history of changes in, or disputes with, auditors;
 - auditor providing qualified opinion or refusal to sign financials;
 - history of late filing or issuance of financials;
 - weak internal control environment;
 - nontransparent or lacking financial disclosure;
 - weak internal audit function, ineffective audit committee, or both;
 - external constituents' difficulty in understanding reported results or financials because of complexity in operational structure or lack of comparability between reporting periods (e.g., due to impact of successive acquisitions or dispositions), or both.
- *Litigation, Regulatory, and Governmental Actions and Track Record*
 - High or increasing incidence in litigation, or threat thereof, from customers, vendors, competitors, regulators, shareholders, creditors, or government entities
 - Lawsuits suggesting the development of overly aggressive or illicit corporate culture in areas including management misrepresentations, product deficiency, excessive executive compensation and benefits or perks, company loans to executives, accounting and reporting irregularities, fraudulent or coercive sales, price fixing and illegal "market cornering" activities, or failure to supervise (management negligence)
 - Sizable contingent liabilities exist or have material chance of developing; establishment of material reserves for future litigation costs/liabilities
 - Increased incidence of regulatory scrutiny, actions, or penalties (including forced restatement, refiling of various reports or tax audits)