

THE 4-STEP AUDIT WORKFLOW

Score the gap. Size the position. Document the decision.

Dyer, Lang & Stice-Lawrence (2017) showed three of 150 topics drove the post-1996 10-K length growth. The testable signal lives in three SEC-mandated sections: **Item 1A**, **Item 7**, and **Item 8**. Use this checklist to convert qualitative reading into a position-risk dollar exposure before you click buy.

Company / Ticker	_____	Filing Date	_____
Position Size \$	_____	Audit Date	_____
Earnings-Call Date	_____	Auditor	_____

STEP

1

≈ 2 min

Map the management story

- Pull the most recent earnings-call transcript or investor presentation.
- Write the three biggest claims on revenue, margins, and forward guidance.
- Score overall narrative confidence on a 0-100 scale BEFORE opening the 10-K.

Narrative score: _____ / 100

0 = vague / boilerplate; 100 = explicit, quantified, reconciled

STEP

2

≈ 4 min

Score Item 1A risk factors

- Skim Item 1A for risks that directly contradict the management narrative.
- Count contradictions. Weight by severity (1x, 2x, 3x).
- Filing support = 100 minus the weighted contradiction count.

Filing support: _____ / 100

Campbell et al. (2014) — Item 1A moves filing-day trading volume.

STEP

3

≈ 6 min

Read Item 7 MD&A for honesty signals

- Check explicit margin-movement explanations.
- Check cash-flow reconciliation language (operating vs reported earnings).
- Check qualifications attached to forward guidance.
- Vague revenue-recognition or aggressive accrual language → reduce filing support.

MD&A score: _____ / 100

Reduce filing support if walk-back or aggressive accrual detected.

<p>STEP</p> <p style="font-size: 2em; font-weight: bold; color: #0070c0;">4</p> <p>≈ 3 min</p>	<p>Score Item 8 financial statements + audit opinion</p> <ul style="list-style-type: none"> ■ Operating cash flow should track reported earnings within reasonable bounds. ■ Read the auditor's opinion. Unmodified? Going-concern footnote? Restatement language? ■ Going-concern OR fresh restatement → red-flag multiplier = 2.0x. <p>Red-flag multiplier: _____ / 100</p> <p><i>1.0 baseline / 1.5 hedged / 2.0 going-concern or restatement</i></p>
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EVIDENCE-GAP CALCULATION

Convert the score into a dollar exposure

FORMULA
$\text{Gap} = \max(0, \text{narrative} - \text{filing})$ $\text{Exposure} = \text{Position} \times (\text{Gap} / 100) \times \text{Downside} \times \text{Multiplier}$

Your numbers

	Variable	Value	Source
A	Position size (\$)	\$ _____	From buy ticket
B	Narrative score (Step 1)	_____ / 100	Earnings-call read
C	Filing support score (Step 2+3)	_____ / 100	Item 1A + 7
D	Gap = max(0, B – C)	_____ pts	calc
E	Downside scenario	_____ %	stress assumption
F	Red-flag multiplier (Step 4)	_____ x	1.0 / 1.5 / 2.0
	Exposure = A × (D/100) × E × F	\$ _____	DOLLAR ANSWER

Decision band

Gap range	Action	Position sizing rule
0 – 19 pts	BUY	Proceed at planned position size.
20 – 39 pts	WATCHLIST	Hold off; re-test next quarter or after MD&A clarification.
40+ pts	RED FLAG	Reduce or skip. If multiplier = 2.0 → cut entirely.

Worked example — Maya Park, \$18,000 add-on

Variable	Maya's value	Calculation
A — Position	\$18,000	—
B — Narrative	80	Q4 call sounded clean
C — Filing support	45	3 Item 1A risks contradicted guidance
D — Gap	35 pts	$\max(0, 80 - 45)$
E — Downside	20%	stress scenario
F — Multiplier	1.0x	no going-concern / no restatement
Exposure → Decision	\$1,260 → WATCHLIST	$18,000 \times 0.35 \times 0.20 \times 1.0 \cdot \text{gap } 20-39$

Sources: Dyer, Lang & Stice-Lawrence (2017) *JAE*; Campbell, Chen, Dhaliwal, Lu & Steele (2014) *RAS*; Bushman & Smith (2001) *JAE*; SEC Form 10-K Instructions (sec.gov/files/reada10k.pdf).

Use: Print one per ticker. File with the buy ticket. Re-run before each annual filing or after material guidance update.

Limits: Single-period evidence-gap model. Does not replace full DCF, accrual-quality, or bankruptcy analysis. For multi-asset decisions, pair with asset-allocation and rebalancing workflows on TheFinSense.io.