Filing Season Finds: Tuesday, March 14

Our latest forensic accounting red flag is from a company whose financial statements may not be entirely reliable.

We pulled this highlight from yesterday's research of 94 10-K filings, from which our robo-analyst technology collected 11,843 data points. Our analyst team used this data to make 1,961 forensic accounting adjustments with a dollar value of $79 billion. The adjustments were applied as follows:

- 779 income statement adjustments with a total value of $7 billion
- 848 balance sheet adjustments with a total value of $43 billion
- 334 valuation adjustments with a total value of $29 billion

Figure 1: Filing Season Diligence

	Filings Parsed	Data Points Collected	# of Adjustments	Total Value of Adjustments ($Billions)
Yesterday	94	11,843	1,961	$79
Filing Season Total	1,624	229,410	39,039	$12,996

Sources: New Constructs, LLC and company filings.

We believe this research is necessary to close the gap between the suitability and fiduciary standard of investment advice services.

Today's Forensic Accounting Needle In A Haystack Is For Technology Investors

Analyst Cody Fincher found an unusual item yesterday in Acacia Research Corporation's (ACTG) 10-K.

On page 45, ACTG disclosed that auditor Grant Thornton LLP had identified a material weakness in its internal control over financial reporting. Specifically, it was determined that ACTG lacked the technical expertise to handle complicated and unusual accounting matters, which led to the misapplication of standards around employee stock compensation.

As we've previously discussed, any material weakness in internal control is a cause for concern and leads to a higher risk of a stock price crash. This particular weakness is especially concerning given ACTG's increased reliance on employee stock compensation. The company began the year with just 15 thousand options outstanding, and ended with 5.6 million. ACTG's employee stock option liability now totals ~$13 million, or 5% of its market cap.

This article originally published here on March 14, 2017.

Disclosure: David Trainer, Cody Fincher, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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