Filing Season Finds: Thursday, March 9

Our latest forensic accounting red flag is from a pharmaceutical giant that managed to use an accounting loophole to turn underperforming drugs into major growth in GAAP net income.

We pulled this highlight from yesterday's research of 63 10-K filings, from which our robo-analyst technology collected 8,240 data points. Our analyst team used this data to make 1,379 forensic accounting adjustments with a dollar value of $200 billion. The adjustments were applied as follows:

- 590 income statement adjustments with a total value of $13 billion
- 558 balance sheet adjustments with a total value of $87 billion
- 231 valuation adjustments with a total value of $100 billion

Figure 1: Filing Season Diligence

	Filings Parsed	Data Points Collected	# of Adjustments	Total Value of Adjustments ($Billions)
Yesterday	63	8,240	1,379	$200
Filing Season Total	1,424	204,228	34,757	$12,259

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 Healthcare Investors

Analyst Cody Fincher found an unusual item yesterday in Astrazeneca PLC's (AZN) 20-F (the international equivalent of a 10-K).

On page 148, AZN disclosed that it earned a credit of $999 million due to changes in the fair value of its contingent consideration liability. AZN bought out Bristol-Myers Squibb's (BMY) share of their joint diabetes business in 2014. The acquisition price included the promise of a further payment if the drugs in the diabetes business hit certain targets. Now that those drugs are underperforming, AZN is less likely to have to make that additional payment, so it gets to decrease the value of the liability and record that decrease as income.

This $999 million credit accounted for 20% of AZN's reported pre-tax operating profit in 2016. Coincidentally, AZN grew its GAAP EPS by ~20%. When we remove this hidden non-operating income, we see that net operating profit after tax (NOPAT) actually decreased by 1%. Investors that ignore the footnotes would have a very misleading view of AZN's profitability.

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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.

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ANSWER: They should not.

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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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