



Filing Season Finds: Wednesday, March 15

Our latest forensic accounting red flag is from an investment management firm with reported profit growth that comes entirely from unusual tax gains.

We pulled this highlight from yesterday's research of 51 10-K filings, from which our [robo-analyst](#) technology collected 6,534 data points. Our analyst team used this data to make 1,064 forensic accounting [adjustments](#) with a dollar value of \$37 billion. The adjustments were applied as follows:

- 449 income statement adjustments with a total value of \$2 billion
- 436 balance sheet adjustments with a total value of \$16 billion
- 179 valuation adjustments with a total value of \$18 billion

Figure 1: Filing Season Diligence

	Filings Parsed	Data Points Collected	# of Adjustments	Total Value of Adjustments (\$Billions)
Yesterday	51	6,534	1,064	\$37
Filing Season Total	1,675	235,944	40,103	\$13,032

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 Financial Investors

Analyst Lindsay Bohannon found an unusual item yesterday in Pzena Investment Management's (PZN) 10-K.

On [page 37](#), PZN disclosed a \$62 million income tax benefit due to a change in their valuation allowance. Previously, PZN did not believe it would earn enough profit to recognize the benefits from much of its [deferred tax assets](#), so it was forced to recognize a valuation allowance that decreased the value of those assets on its balance sheet.

In 2016, PZN increased its assets under management to the point where it now believes it will be able to realize the entirety of its deferred tax assets, so it decreased the valuation allowance and recognized that decrease as an income tax benefit.

This income tax benefit allowed PZN to more than double its reported GAAP net income. When we remove that benefit and give PZN a [more normal tax rate](#), we see that net operating profit after tax ([NOPAT](#)) actually declined by 44%, from \$50 million to \$28 million. Investors who rely only on the financial statements get a misleading view of PZN's profitability.

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Disclosure: David Trainer, Lindsay Bohannon, 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.

Additional Information

Incorporated in July 2002, [New Constructs](#) is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. [NOPAT](#), [Invested Capital](#), and [WACC](#), to create [economic earnings models](#), which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).

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