

THE INVESTMENT MERITS OF FORENSIC ACCOUNTING

Successful stock investing is not an easy proposition.

Most stocks underperform stock averages. Many even destroy the hard earned capital invested in them. One study focusing on the Russell 3000 from 1983 - 2007 produced the following conclusions concerning the over 8,000 stocks analyzed:

(Source: The Capitalism Distribution Study)

64% of stocks underperformed the Russell 3000.

39% of stocks lost money.

25% of stocks accounted for all gains.

More recently, analysis of the Russell 3000's 12-month performance shows that 53.2% of stocks included in the index underperformed the overall index. In addition, 43.1% of stocks in the index lost value while 22.8% lost 20% more. Source: Bloomberg (data from February 13, 2014 – February 13, 2015)

Many investors just focus on finding the winners when it comes to investing. Yet it is clearly important to avoid stocks that underperform or lose money. Here's a mathematical chart illustrating the cost of losing. (Source: Index Deletion Strategies)

How Can Investors Identify The Losers?

One method to potentially avoid stock market losers is through forensic accounting. Also called financial statement analysis, this method uses publicly available financial reports to search for the "red flags" of aggressive accounting practices that some companies have been found to employ. Red flags often indicate underlying business problems and will usually end up reflected in the price of a company's stock.

If you lose...	To break even you need...
5%	5%
10%	11%
15%	18%
20%	25%
25%	33%
30%	43%
35%	54%
40%	67%
45%	82%
50%	100%
75%	300%
90%	900%

Types of red flags identified by forensic accounting may include:

- Fictitious Revenue
- Accelerated Revenue Recognition
- Inventory issues
- Unsustainable Margin Expansion
- Financial ratio adjustments

Invest In Companies With Strong Financial Statements

Besides identifying potential losers, forensic accounting may also identify companies with attractive earnings quality and strong financials. These metrics have historically been desirable to investors.

Two investment principals derived from forensic accounting are:

Invest in companies with high quality earnings.

Avoid companies with red flags in financial statements.


Useful In All Types Of Markets

Forensic accounting is used in both bear and bull equity markets to identify risks and opportunities. Performing a complete financial statement analysis of a group of companies may reveal red and green flag companies. Using this knowledge may be an effective investment strategy to manage downside risk while potentially improving upside potential.

The Forensic Accounting ETF (FLAG) was developed to offer the potential benefits of financial statement analysis to all investors.

FLAG seeks to provide investment results that, before fees and expenses, correspond generally to the price and yield performance of the Del Vecchio Earnings Quality Index. This index uses financial statement analysis to avoid companies with aggressive accounting and revenue recognition while investing in companies that have high earnings quality. Earnings quality is defined as the degree of sustainable earnings as reported by a company. (Source: Index Deletion Strategies)

Companies included in the Del Vecchio Earnings Quality Index are derived from a universe of 500 U.S. large capitalization equities. Each company is assigned a letter grade based on a proprietary forensic accounting examination of the company's publically available financial data. A variety of metrics are analyzed, as shown in the chart below.

Income Statement		
Metric	Concern	Most Critical
Revenue	Aggressive Revenue Recognition	
Costs of Goods Sold	Inventory Issues	
Gross Profit	Reserve Concerns	
Operating Expenses Research & Development Sales, General & Administrative	Large Changes	
Operating Income	Large Changes	
Taxes	Tax Issues	
Net Income		

All companies are graded in a range of “A – F”, with “F” being the lowest possible earnings quality grade. The index excludes companies graded “F”. The remaining companies are weighted as follows:

Companies graded A = 40% of the index

Companies graded B, C, D = 20% of the index respectively

All companies within each letter grade are equally weighted. The grading of 500 companies is performed on a monthly basis and the **Del Vecchio Earnings Quality Index** is reconstituted semi annually.

Del Vecchio Earnings Quality Index Details

Symbol: FLAG INDEX

Number of Holdings: 400

The Forensic Accounting ETF (FLAG) offers investors an efficient path to invest in the opportunities identified by forensic accounting.

Forensic Accounting ETF Information

Ticker: FLAG

IOPV Ticker: FLAG.IV

Listing Exchange: NYSE ARCA

Expense Ratio: 0.85%

Inception Date: 1/30/13

CUSIP: 301505400

Distributions: Annually

Fund Disclosure

Carefully consider the Fund's investment objectives, risk factors, charges and expenses before investing. This and additional information can be found in the Fund's prospectus, which may be obtained by visiting www.flageff.com. Read the prospectus carefully before investing.

Investing involves risk, including the possible loss of principal. The Index may include REITs. Adverse economic, business or political developments affecting real estate could have a major effect on the value of the Fund's investments in REITs. Investing in REITs may subject the Fund to risks associated with the direct ownership of real estate, such as decreases in real estate values, overbuilding, increased competition and other risks related to local or general economic conditions, increases in operating costs and property taxes, changes in zoning laws, casualty or condemnation losses, possible environmental liabilities, regulatory limitations on rent and fluctuations in rental income. In addition, REITs are subject to the possibility of failing to qualify for tax-free pass-through of income under the Internal Revenue Code and maintaining exemption from the registration requirements of the Investment Company Act of 1940, as amended.

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