Economic Earnings: Explanation & Examples

Economic earnings represent the true earnings for shareholders and are very different from accounting earnings. GAAP accounting data was not originally designed for equity investors, but for debt investors.

To derive economic earnings, 30+ adjustments must be made to accounting earnings. These adjustments remove items hidden in the footnotes and MD&A of annual filings and close loopholes within GAAP accounting.

The formulae for economic earnings are in Figure 1. For more on economic earnings, see here.

Figure 1: How To Calculate Economic Earnings

NOPAT – WACC * Invested Capital

Or

(ROIC – WACC) * Invested Capital

Sources: New Constructs, LLC and company filings

Economic earnings are better than accounting earnings because

1. They are based on the complete set of financial information available
2. They are normalized for all companies
3. They are a more accurate representation of the true underlying cash flows of business.

If a company is not generating positive economic earnings, it is not creating shareholder value. Figure 2 shows which companies are creating and destroying the most value.

Figure 2: Companies With Highest/Lowest Economic Earnings

Ticker	Name	Economic Earnings	Stock Rating
Highest Economic Earnings			
AAPL	Apple Inc.	$51,259	Attractive
GILD	Gilead Sciences	$15,830	Very Attractive
MSFT	Microsoft Corporation	$13,866	Attractive
CHL	China Mobile Limited	$11,223	Very Attractive
GOOGL	Alphabet Inc.	$11,116	Neutral
Lowest Economic Earnings			
C	Citigroup Inc.	($18,170)	Neutral
DB	Deutsche Bank AG	($18,976)	Dangerous
LYG	Lloyds Banking Group PLC	($19,296)	Very Dangerous
CVX	Chevron Corporation	($20,784)	Dangerous
ETR	Entergy Corporation	($27,578)	Very Dangerous

Sources: New Constructs, LLC and company filings. Only includes companies with positive NOPAT

Out of 3000+ companies, Apple (AAPL) earns the largest economic earnings at over $51 billion. See Apple's historical economic earnings dating back to 1998 here. Apple has earned positive economic earnings every year dating back to 2004. Gilead Sciences (GILD), Microsoft Corporation (MSFT), China Mobile Limited (CHL), and Alphabet (GOOGL) each generate some of the highest economic earnings of all companies under coverage. In order to be as transparent as possible, we provide a reconciliation of GAAP net income to economic earnings in each of our company models. Investors only stand to benefit from increased transparency, which is why our calculations are made available in each company model. The reconciliation of Gilead's GAAP net income to economic earnings can be found here.

Entergy Corporation (ETR) generates the lowest, or most negative economic earnings of all companies under coverage. See Entergy's historical economic earnings dating back to 1998 in our model here. As can be seen in our model, Entergy has failed to generate positive economic earnings in any year of our model. The company has consistently increased its invested capital while not generating a subsequent increase in profits, thereby destroying shareholder value in the process. See the reconciliation of GAAP net income to economic earnings here. Citigroup (C), Deutsche Bank (DB), Lloyds Banking Group (LYG), and Chevron Corporation (CVX) round out the top five companies with the lowest economic earnings.

Our models and calculations are 100% transparent because we want our clients to know how much work we do to ensure we give them the best earnings quality and valuation models in the business.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, sector, style, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

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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