How We Calculate Earnings Distortion Scores

As a short-term predictor of the likelihood of a company to miss expectations in the next quarter, our Earnings Distortion Score compliments, but does not override, our longer-term Risk/Reward ratings.

We measure Earnings Distortion (as featured on CNBC Squawk Box) using a proprietary human-assisted ML technology featured in a recent paper from Harvard Business School (HBS) and MIT Sloan. This paper empirically shows that CompuStat and street earnings estimates are incomplete and less accurate since they do not consistently and accurately adjust for unusual gains/losses buried in footnotes.

We leverage our proprietary dataset of unusual gains/losses to derive Earnings Distortion Scores for ~3,000 stocks. These scores indicate how likely companies are to beat or miss estimates based on how much unusual gains/losses cause unadjusted earnings measures to be over/understated.

The Earnings Distortion Score formula is: **Core Earnings Distortion divided by Total Assets**

We decile these values and, then, categorize into a 5-tier scoring system:

1. Strong Beat – Top Decline (Least earnings distortion)
2. Beat – Second and third Decile
3. In line – Fourth, fifth, sixth and seventh decline
4. Miss – Eighth and ninth decile
5. Strong Miss – Bottom decile (Most earnings distortion)

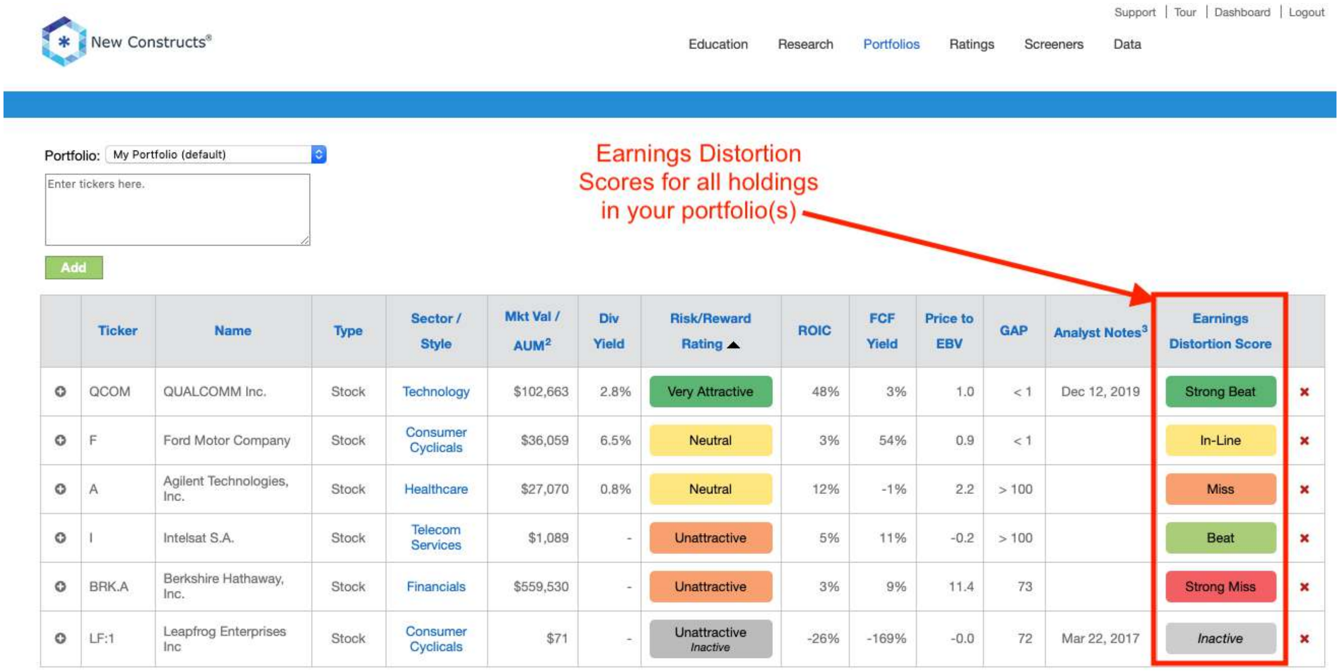
We scale core earnings distortion by total assets so large companies don't dominate the rankings, as they are likely to have more earnings distortion simply due to their size. Further, this approach mirrors the strategy in "Core Earnings: New Data and Evidence", which presents a long/short strategy that delivers abnormal returns of 7-10% annually based on our proprietary Earnings Distortion data.

Our Earnings Distortion Scores empower investors to combat management manipulation of earnings. For more on how to use our Earnings Distortion Scores, click here.

Get Earnings Distortion Scores for All ~3000 Stocks Under Coverage

All members get our Earnings Distortion Scores for the stocks in their portfolios. Per Figure 1, you'll see the Earnings Distortion Score at the far right of your Portfolios.

Figure 1: Earnings Distortion Scores on the Portfolios Page

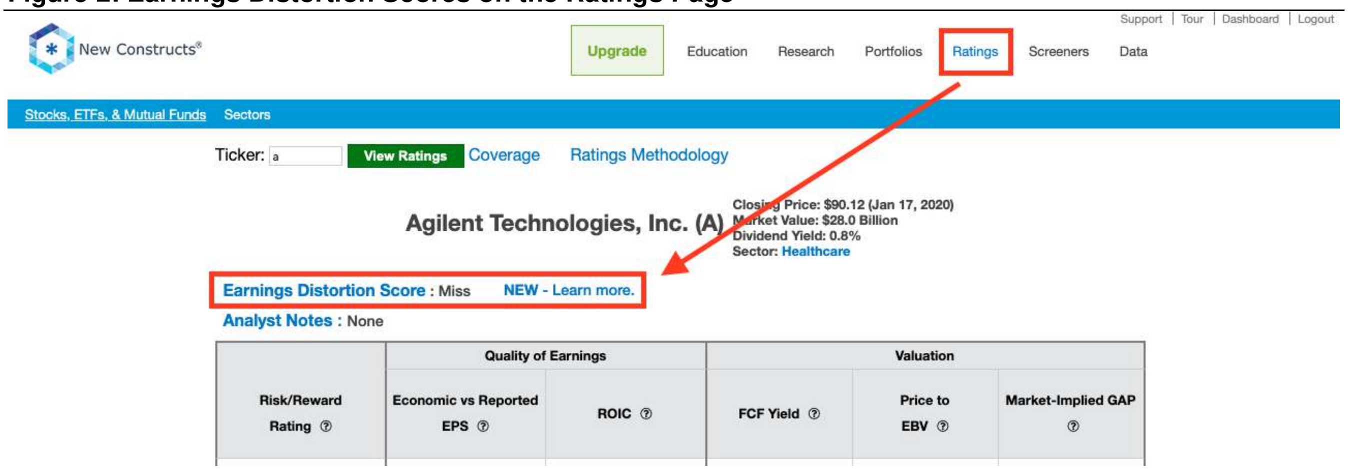


	Ticker	Name	Type	Sector / Style	Mkt Val / AUM²	Div Yield	Risk/Reward Rating	ROIC	FCF Yield	Price to EBV	GAP	Analyst Notes³	Earnings Distortion Score	
	QCOM	QUALCOMM Inc.	Stock	Technology	$102,663	2.8%	Very Attractive	48%	3%	1.0	< 1	Dec 12, 2019	Strong Beat	×
	F	Ford Motor Company	Stock	Consumer Cyclicals	$36,059	6.5%	Neutral	3%	54%	0.9	< 1		In-Line	×
	A	Agilent Technologies, Inc.	Stock	Healthcare	$27,070	0.8%	Neutral	12%	-1%	2.2	> 100		Miss	×
	I	Intelsat S.A.	Stock	Telecom Services	$1,089	-	Unattractive	5%	11%	-0.2	> 100		Beat	×
	BRK.A	Berkshire Hathaway, Inc.	Stock	Financials	$559,530	-	Unattractive	3%	9%	11.4	73		Strong Miss	×
	LF:1	Leapfrog Enterprises Inc	Stock	Consumer Cyclicals	$71	-	Unattractive Inactive	-26%	-169%	-0.0	72	Mar 22, 2017	Inactive	×

Sources: New Constructs, LLC and company filings

Platinum and higher members also get our Earnings Distortion Scores on the Ratings page. Per Figure 2, the Earnings Distortion Score will display above Analyst Notes on the Ratings page.

Figure 2: Earnings Distortion Scores on the Ratings Page



Sources: New Constructs, LLC and company filings

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

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.

Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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