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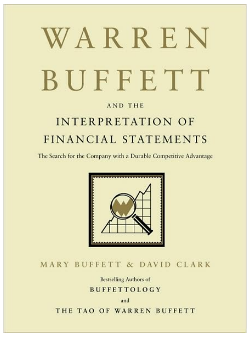

Warren Buffett and the Interpretation of Financial Statements

by Mary Buffett and David Clark
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224 pages

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Take-Aways

- Warren Buffett invests in high-quality companies with “durable competitive advantages.”
- He favors businesses that sell unique products or services, or sell at the lowest price.
- Income statements, balance sheets and cash flow statements reveal a firm’s potential.
- Companies with net incomes consistently at or more than 20% of revenues often are industry leaders.
- Avoid investing in companies with high expenses for research, depreciation and interest.
- Companies with strong liquidity and little external debt are likely to “sail on through the troubled times.”
- Buffett prefers companies that build retained earnings to those that pay dividends.
- He has amassed $64 billion in unrealized capital gains on stock he owns in his company, Berkshire Hathaway.
- Buffett sees stocks as “equity bonds” with ever-rising “yields,” or earnings per share.
- Consider selling any stock priced more than 40 times its earnings per share.

Rating (10 is best)

Overall	Applicability	Innovation	Style
8	**9**	**8**	**8**

Relevance

What You Will Learn

In this Abstract, you will learn: 1) How Warren Buffett uses financial statements to identify superior companies with solid competitive advantages, 2) What he looks for in three types of financial statements and 3) Why he pays special attention to certain ratios.

Recommendation

Financial statements hold clues about the future performance of a company, and Warren Buffett's quest to find such clues has put him among the ranks of the wealthiest people in the world, according to Buffett experts Mary Buffett (his former daughter-in-law) and David Clark. Seeing the interpretation of financial statements through Warren Buffett's eyes is both instructive and insightful. He routinely calculates meaningful financial ratios from line items in financial statements to distinguish the most promising companies from the rest. Although financial novices may have the most to learn from this book, the authors include savvy bits of "Buffettology" for more seasoned investors' benefit. *getAbstract* recommends this book to readers who want a basic introduction to financial statement analysis and, perhaps more importantly, who want to learn how "the Oracle of Omaha" picks his winning investments.

Abstract

The Divergent Styles of Warren Buffett and His Mentor

In the 1950s, an economist and professional investor named Benjamin Graham served as a mentor to Warren Buffett, who went on to become one of the world's wealthiest people. Graham pioneered the practice of value investing – that is, buying into companies with low stock prices. Buffett, Graham's student at New York's Columbia University, later worked as an analyst at Graham's Wall Street investment firm.

"Warren [Buffett] has learned that time will make him superrich when he invests in a company that has a durable competitive advantage working in its favor."

When he started his own investment business, Buffett altered the Graham method of value investing in several ways. For one, Buffett ignores the Graham rule of selling stocks after they appreciate by 50%, because sometimes their prices will rise much more. Graham would buy a stock based primarily on its cost – the lower, the better. Buffett favors high-quality companies with predictable cash flows, so he is inclined to pay a "fair price" for their shares, not necessarily the lowest amount possible. Graham espoused the importance of holding a diversified portfolio of stocks, increasing the odds that moneymaking stocks would offset losers. Buffett prefers a portfolio concentrated on a few stocks that he regards as excellent investments.

"The place that Warren goes to discover whether or not the company has a 'durable' competitive advantage is its financial statements."

Buffett studies the financial statements of companies to distinguish the best from the rest. He believes that top firms share certain financial characteristics. He invests only in financially self-sustaining companies with such a strong "durable competitive advantage" over their rivals that it creates "monopoly-like economics, allowing them either to charge more or to sell more."

Three Business Models That Buffett Likes Best

The companies that attract Buffett's investment operate one of three business models: "They sell either a unique product or a unique service, or they are the low-cost buyer and seller of a product or service the public consistently needs." Firms that sell unique products include, for instance, beer brewer Budweiser, soft drink producer Coca-Cola and candy maker Hershey. Many other companies sell beer, soda and chocolate, but they lack the singular brand power of Bud, Coke and Hershey's. Examples of companies that sell uniquely branded services include credit rating agency Moody's Corp., tax service provider H&R Block, Inc. and bank Wells Fargo & Co. Retail chains Walmart and Costco, and the Burlington Northern Santa Fe Railway, fit into the third type of business model: the lowest-cost provider of such staples as food and clothing or such fundamental services as transportation. Buffett favors these and other well-known companies with brands so powerful they command "a piece of the consumer's mind."

"When Warren is looking at a company's financial statement, he is looking for consistency."

Hunting for Value in Financial Statements

Warren Buffett reads three types of financial statements to learn about a business: its income statement, its balance sheet and its cash flow statement. He analyzes these statements individually and collectively to discern the truth about a company's prospects and the value of its stock.

"Warren knows that one of the great secrets to making more money is spending less money."

The income statement, issued quarterly and annually, summarizes revenue, operating costs, overhead expenses and net results, which are either profits or losses. The cash flow statement accounts for cash provided or consumed by operations, investments and financing activities over a period of time. In contrast, the balance sheet captures the condition of a firm at one point; it summarizes the state of assets and liabilities on a particular date. Buffett compares different line items on financial statements to assess the strengths and weaknesses of companies. For example, he subtracts the cost of goods sold (materials and labor) from revenue to determine gross profit, and then divides gross profit by revenue to calculate the company's gross profit margin. A firm that reliably achieves margins of 40% or more probably has a durable competitive advantage.

"Warren has learned over the years that companies that are busy misleading the IRS are usually hard at work misleading their shareholders as well."

Companies' operating activities generate their selling, general and administrative (SGA) expenses, such as executive compensation, advertising fees and legal costs. Like many line items in financial statements, SGA expenses alone convey limited information about an organization and its likely fate. Comparisons of line items are more instructive. For example, Buffett checks the percentage of gross profit these expenses devour. Companies with stable SGA expenses as a percentage of gross profit tend to have dominant positions in their industries. In general, "anything under 30% is considered fantastic."

The Burden of Research, Depreciation and Interest Expenses

Buffett avoids investing in businesses burdened by huge commitments to research and development, preferring instead companies like Coca-Cola, an industry leader that has been selling the same secret-formula beverage for more than 100 years. In some industries, such as information technology, research and development is a critical source of competitive clout. But the pace of technological change is so fast that any competitive advantage from a research breakthrough could prove fleeting. Consider the relative R&D burdens of chewing gum maker Wrigley and automaker General Motors: GM constantly must invest in R&D to design new vehicles, or it risks losing market share. Wrigley has been selling essentially the same popular brand of chewing gum for decades. Which company has been a better investment? By 2008, an investor who bought $100,000 of stock in each company in 1990 would have GM shares worth $97,000 and Wrigley shares worth $547,000.

"While the total revenue number alone tells us very little about the economics of the business, its ratio to net earnings can tell us a lot."

Buffett is not fond of heavy depreciation and interest expenses, either. Depreciation reflects the non-cash cost of wear and tear on operating assets, such as buildings and equipment. Buffett likes to invest in companies with depreciation expenses that are low as a percentage of gross profits. Similarly, he routinely seeks businesses with annual interest payments that consume the smallest possible fraction of gross profit – the less interest expense, the less debt the firm is carrying.

"Making chewing gum is a much better and a far more profitable business for shareholders than making cars."

Rating Companies by Their Returns on Revenue

Profitable companies divide their net income by the number of their outstanding common shares to determine earnings per share, a financial metric that securities analysts widely use. However, Buffett pays more attention to net income in his appraisal of companies. He divides net income by revenue to calculate a firm's return on revenue and, in turn, to assess its competitive position. If its return on revenue is consistently greater than 20%, the company probably has a pivotal, ongoing advantage over the rest of its industry. If its return on revenue is steadily below 10%, the firm likely operates in an intensely competitive field. Many companies have returns from 10% to 20%, and some of them represent "long-term investment gold that no one has yet discovered."

The Asset Side of the Balance Sheet

"In the business world, durability of a competitive advantage is a lot like virginity – easier to protect than it is to get back. "

The balance sheet shows a firm's assets, liabilities and shareholders' equity at a certain date. Total assets minus total liabilities equal equity. These three balance sheet components convey important information about a firm's probable future. Current assets include cash and liquid investments as well as inventory and accounts receivable that the firm can convert to cash within a year. These "working assets" and their amounts vary depending on the company's day-to-day operations. Cash relative to accounts receivable may fluctuate, for instance, as business conditions change. Non-current assets include property, plant and equipment, and such intangibles as franchises, copyrights and patents.

Buffett likes to see a strong cash and liquid investments position paired with little external debt. Businesses with this profile are rather likely to "sail on through the troubled times." Buffett also calculates the net amount of accounts receivable, or receivables minus bad debts, as a percentage of sales revenue; companies with a low percentage often are leaders in their industries.

"The rule here is simple: Little or No Long-Term Debt Often Means a Good Long-Term Bet."

The Liability Side of the Balance Sheet

Current liabilities are debts due within one year. These include accrued expenses, accounts payable and short-term loans. Other classes of liabilities include long-term debt maturing in more than one year. In general, companies with an enduring edge over their rivals are generating enough cash internally to preclude the need to accumulate large amounts of long-term debt.

The ratio of current assets to current liabilities, or the "current ratio," is a common measure of corporate liquidity. In conventional analysis, a current ratio of more than one indicates better liquidity than a ratio of less than one. But, according to Buffett, certain companies with a commanding advantage have current ratios below one because their reliably solid businesses negate the need for a big "liquidity cushion" against insolvency. Buffett applies the same argument to the ratio of long-term debt to shareholders' equity: Some companies that lead their industries have higher debt-to-equity ratios because they use a big portion of their net income to repurchase stock or pay dividends. These two uses of earnings both affect the growth of shareholders' equity, but neither indicates that a company is facing fierce competitive pressure.

"Finding what one is looking for is always a good thing, especially if one is looking to get rich."

The Magic of Retained Earnings

Retained earnings represent net income that a company reinvests in its operations instead of spending it on stock repurchases or dividend payments. Retained earnings are a component of shareholders' equity on the balance sheet; in fact, amassing retained earnings increases shareholders' equity, or the firm's net worth. Buffett believes companies with rapidly growing retained earnings are also likely to have a long-term advantage over their competitors.

"Occasionally even a company with a durable competitive advantage can screw up and do something stupid...Think New Coke."

Buffett runs a publicly traded investment holding company called Berkshire Hathaway that does not pay dividends to its shareholders. This policy has helped Berkshire accumulate a mountain of retained earnings, contributing to a significant, long-term increase in the firm's value: Its pretax earnings per share rose from $4 in 1965 to $13,023 in 2007. Buffett prefers stock repurchases to dividend payments as a means of rewarding shareholders. By buying back its own shares, a company can increase its earnings per share without actually earning more net income; as earnings per share increase, the price of the shares is likely to increase, too.

Tax liability is a major consideration. If Buffett received dividends on his Berkshire stock, he would have to pay income tax on them. Instead, he will accumulate capital gains on his Berkshire stock tax-free as long as he holds the stock. He has already stockpiled $64 billion of unrealized capital gains on his Berkshire shares and had not yet paid any tax on these paper profits.

"To get rich, we first have to make money, and it helps if we can make lots of money."

Buying, Holding and Selling "Equity Bonds"

Because Berkshire Hathaway makes long-term investments in companies with substantial, sustainable competitive advantages, it owns stocks that behave like bonds with yields that rise over time. Buffett calls these stocks "equity bonds." Instead of a regular bond's cash interest payments, the yield on an equity bond is the company's earnings per share. And as earnings per share grow over time, so does yield on an equity bond. For instance, during the late 1980s, Buffett bought stock in Coca-Cola at prices averaging $6.50 per share at a time when the company had annual earnings of 46 cents per share, "which in Warren's world equates to an initial rate of return of 7%. By 2007, Coca-Cola was earning $2.57 a share," translating to a 39.9% return on his original investment.

"Some men read Playboy. I read annual reports." (Warren Buffett)

Buffett is a long-term investor in the stocks of companies with durable competitive advantages because "the longer you hold on to them, the better you do." Nevertheless, three types of circumstances make selling a great stock advisable: if proceeds from the sale could fund a better investment, if the company is ceding its competitive advantage or if the price of the firm's shares soars in an overheated bull market. If the stock price of a company is 40 times more than its annual earnings per share, "it just might be time to sell." But rather than buy another stock trading at 40 times earnings, Buffett prefers to hold on to his cash until the market settles down and great equity bonds once again become available at affordable prices. Clearly, the Buffett style of investing requires patience, but the potential payoff is enormous.

About the Authors

Mary Buffett and **David Clark** have written four other books on how Warren Buffett makes investment decisions. An author and speaker, she was Warren Buffett's daughter-in-law from 1981 to 1993. Clark is the managing partner of a private investment group.