

This is How Buffett Interprets Financial Statements

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Warren Buffett is one of a kind and while he provides amazing insight and knowledge year after year in his letters and speeches, details about how to choose companies and what to look for is lacking.

[Warren Buffett and the Interpretation of Financial Statements](#) is a book that manages to explain how Buffett interprets financial statements which we will go through.

How Warren Buffett Interprets the Income Statement

When it comes to [analyzing the income statement](#), it is important to investigate further and drill down to detect what the [quality of earnings](#) are made up of and what the numbers interpret.

Gross Profit Margin: firms with excellent long term economics tend to have consistently higher margins

- Durable competitive advantage creates a high margin because of the freedom to price in excess of cost
- Greater than 40% = Durable competitive advantage
- Less than 40% = competition eroding margins
- Less than 20% = no sustainable competitive advantage
- Consistency is key

Sales Goods and Administration : Consistency is key.

Companies with no durable competitive advantage show wild variation in SG&A as % of gross profit

- Less than 30% is fantastic
- Nearing 100% is in highly competitive industry

R&D: if competitive advantage is created by a patent or tech advantage, at some point it will disappear.

- High R&D usually dictates high SG&A which threatens the competitive advantage

Depreciation: Using EBITDA as a measure of cash flow is very misleading

- Companies with durable competitive advantages tend to have lower depreciation costs as a % of gross profit

Interest Expenses: Companies with high interest expenses relative to operating income tend to be either:

1) in a fiercely competitive industry where large capital expenditure required to stay competitive

2) a company with excellent business economics that acquired debt in leveraged buyout

- Companies with durable competitive advantages often carry little or no interest expense.
- Warren's favorites in the consumer products category all have less than 15% of operating income.
- Interest expenses varies widely between industries.

- Interest ratios can be very informative of level of economic danger.

Important: *In any industry, the company with the lowest ratio of interest to Operating Income is usually the one with the competitive advantage.*

Net Earnings

- Look for consistency and upward long term trend.
- Because of share repurchase it is possible for net earnings trend to differ from EPS trend.
- Preferred over EPS
- Durable competitive advantage companies report higher % net earnings to total revenues.

Important: *If a company is showing net earnings history greater than 20% on total revenues, it is probably benefiting from a long term competitive advantage.*

- If net earnings is less than 10%, likely to be in a highly competitive business

How Warren Buffett Interprets the Balance Sheet

Cash and Equivalents:

A high number means either:

- 1) The company has competitive advantage generating lots of cash
- 2) Just sold a business or bonds (not necessarily good)

A low stockpile of cash usually means poor to mediocre economics.

There are 3 ways to create large cash reserve.

- 1) Sell new bonds or equity to public
- 2) Sell business or asset
- 3) It has an ongoing business generating more cash than it burns (usually means durable competitive advantage)

When a company is suffering a short term problem, Buffett looks at cash or marketable securities to see whether it has the financial strength to ride it out.

Important: *Lots of cash and marketable securities + little debt = good chance that the business will sail on through tough times.*

- Test to see what is creating cash by looking at past 7 yrs of balance sheets. This will reveal how the cash was created.

Inventory

- Manufacturers with durable competitive advantages have the advantage that the products they sell do not change, and therefore will never become obsolete. Buffett likes this advantage.
- When identifying manufacturers with durable competitive advantage, look for inventory and net earnings that rise correspondingly. This indicates that the company is finding profitable ways to

increase sales which called for an increase in inventory.

- Manufacturers with inventories that spike up and down are indicative of competitive industries subject to boom and bust.

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Net Receivables

Net receivables tells us a great deal about the different competitors in the same industry. In competitive industries, some attempt to gain advantage by offering better credit terms, causing increase in sales and receivables.

If company consistently shows lower % Net receivables to gross sales than competitors, then it usually has some kind of competitive advantage which requires further digging.

Property, Plant & Equipment

A company with durable competitive advantage doesn't need to constantly upgrade its equipment to stay competitive. The company replaces when it wears out. On the other hand, a company without any advantages must replace to keep pace.

Difference between a company with a moat and one without is that the company with the competitive advantage finances new equipment through internal cash flows, whereas the no advantage company requires debt to finance.

Producing a consistent product that doesn't change equates to consistent profits. There is no need to upgrade plants which frees up cash for other ventures. Think Coca Cola, Johnson & Johnson etc.

Goodwill

Whenever you see an increase in goodwill over a number of years, you can assume it's because the company is out buying other businesses above book value. GOOD if buying businesses with durable competitive advantage.

If goodwill stays the same, the company when acquiring other companies is either paying less than book value or not acquiring. Businesses with moats never sell for less than book value.

Intangible Assets

- Intangibles acquired are on balance sheet at fair value.
- Internally developed brand names (Coke, Wrigleys, Band-Aid) however are not reflected on the balance sheet.

- One of the reasons competitive advantage power can remain hidden for so long.

Total Assets & Return on Total Assets

- Measure efficiency using ROA
- Capital is barrier to entry. One of things that make a competitive advantage durable is the cost of assets needed to get in. This is why we calculate the [Asset Reproduction Value](#) along with the [EPV](#).
- Many analysts argue the higher return the better. Buffett states that really high ROA may indicate vulnerability in the durability of the competitive advantage.
- E.g. Raising \$43b to take on KO is impossible, but \$1.7b to take on Moody's is. Although Moody's ROA and underlying economics is far superior to Coca Cola, the durability is far weaker because of lower entry cost.

Current Liabilities

Includes accounts payable, accrued expenses, other current liabilities and short term debt.

- Stay away from companies that 'roll over the debt' e.g. Bear Stearns

When investing in financial institutions, Buffett shies from those who are bigger borrowers of short term than long term debt.

- His favorite 'Wells Fargo' has 57 cents short term debt for every dollar of long term
- Aggressive banks (like Bank of America) has \$2.09 short term for every dollar long term

Durability equates to the stability of being conservative.

Long Term Debt coming Due

Some companies lump their yearly long term debt due with short term debt on the balance sheet. This makes it seem like there is more short term debt than the real amount.

Important: *Companies with durable comparable advantages need little or no LT debt to maintain operations.*

Too much debt coming due in a single year spooks investors and can offer attractive entry points.

However, a mediocre company in problems with too much debt due leads to cash flow problems and certain bankruptcy.

Long Term Debt

Buffett says that durable competitive advantages carry little to no LT debt because the company is so profitable that even expansions or acquisitions are self financed.

We are interested in long term debt load for the last ten years. If the ten yrs of operation show little to no long term debt, then the company has some kind of strong competitive advantage.

Buffett's historic purchases indicate that on any given year, the company should have sufficient yearly net earnings to pay all long term within 3 or 4 year earnings period. (e.g. Coke + Moody's = 1yr)

Companies with enough earning power to pay long term debt in less than 3 or 4 years is a good candidate in our search for long term competitive advantage.

- BUT, these companies are targets for leveraged buy outs, which saddles the business with long term debt
- If all else indicates the company has a moat, but it has ton of debt, a leveraged buyout may have created the debt. In these cases the company's bonds offer the better bet, in that the company's earnings power is focused on paying off the debt and not growth.

Important: *little or no long term debt often means a **Good Long Term Bet***

Total Liabilities & Debt to Shareholders Equity Ratio

- Debt to shareholders equity ratio helps identify whether the company uses debt or equity (includes retained earnings) to finance operations.
- Company with a moat uses earning power and should show higher levels of equity and lower level of liabilities.
- *Debt to Shareholders Equity Ratio : Total Liabilities / Shareholders Equity*
- Problem with using as identifier is that economics of companies with durable competitive advantages are so great they don't need large amount of equity or retained earnings on the balance sheet to get the job done.

Important: *if the Treasury Share Adjusted Debt to Shareholder Equity Ratio is less than 0.8, the company has a durable competitive advantage.*

Retained Earnings: Buffett's Secret

One of the most important indicators of durable competitive advantage. Net earnings can be paid out as dividends, used to buy back shares or retained for growth.

If the company loses more than it has accumulated, retained earnings is negative.

- If a company isn't adding to its retained earnings, it isn't growing its net worth.
- Rate of growth of retained earnings is good indicator whether it's benefiting from a competitive advantage.
- Microsoft is negative because it chose to buyback stock and pay dividends
- The more earnings retained, the faster it grows and increases growth rate for future earnings.

Treasury Stock

- Carried on the balance sheet as a negative value because it represents a reduction in shareholders equity.
- Companies with moats have free cash, so treasury shares are hallmark of durable competitive advantages.
- When shares are bought back and held as treasury stock, it is effectively decreasing the company equity. This increases return on shareholders equity.
- High return is a sign of competitive advantage. It's good to know if it's generated by financial engineering or exceptional business economics or combination.
- To see which is which, convert negative value of treasury shares into a positive and add it to shareholders equity. Then divide net earnings by new shareholders equity. This will give the return on equity minus effects of window dressing.

Important: presence of treasury shares and a history of buyback are good indicators that company has competitive advantage

How Warren Buffett Interprets the Cash Flow Statement

Capital Expenditures

Never invest in telephone companies because of big capital outlays

Important: company with durable competitive advantage uses a smaller portion of earnings for capital expenditure for continuing operations than those without.

To compare capex to net earnings, add up total capex for ten-yr period and compare with total net earnings over the same period

Important: if historically using less than 50%, then good place to look for durable competitive advantage. If less than 25%, probably has a competitive advantage.