

WARREN BUFFETT
And the
INTERPRETATION OF FINANCIAL STATEMENTS
2008
BOOK SUMMARY

The following is a summary of Warren Buffet's recent book on financial statements. I recommend this book if you want to learn how to value a company, be a better volunteer treasurer, board member, or leader in your community, when financial statements are required to be reviewed. This 190 page book is a very easy read. It is an excellent book to better understand the **quantitative value of a company** - the economic value. It misses the point of the **qualitative value of an organization** - the qualities, the people, their values etc.

1. INCOME STATEMENTS:

- Income/expense
- Profit/loss
- The source of income – how reliable is it?
- Do you have a long-term advantage over your competitors?
- Look for the margins in the organization.
- The **source** of income is more important than the income itself.
- KISS report: total income – expenses = profit
- The quickest way to make more money is to spend less money.
- Line by line, review the list of expenses to ensure they are required.
- Two key words – **durable** and **consistent** profit

2. OPERATING EXPENSES:

- How do you lose a high gross profit margin? Have high research, high selling and admin costs, and high interest costs on debt

- If a competitive advantage is caused by a patent, that patent will expire and the company will lose its competitive advantage.
 - Technological advantages can always be replaced by others who come up with a better mouse trap.
 - Depreciation is a real cost of doing business, because some day that piece of equipment will have to be replaced.
 - Low expenses = more profits
 - Interest is a financial cost not an operating cost. Companies with a durable competitive advantage often carry little or no interest expense.
 - Page 52 – the company with the lowest ratio of interest payments to operating income is usually the company most likely to have the competitive advantage.
3. **Nonrecurring events** – the sale of assets should not be part of the income statement when determining if a company has a durable competitive advantage.
 4. Some companies will overstate their earnings – look up what they are paying in taxes. See if they match. If these two figures are out of line, start asking questions. Page 58
 5. **Share repurchase programs** – they increase per-share earnings by decreasing the number of shares outstanding.
 6. The more a company earns per share the higher its stock price is.
Corp. net income earned divided by number of shares = Corp. per-share earnings. Eg. Net earnings = \$10 million divided by 1 million shares outstanding = \$10.00 per-share earnings.
 7. Consistent earnings are usually a sign that the company is selling a product or mix of products that don't need to go through the expensive process of change.
 8. Companies with wild swings in their share price may be going on a slow boat to nowhere.
 9. One cannot be too financially prepared in our constantly changing and challenging world.

The balance sheet:

- Life tends to snap at your weakest link. Eg. too much debt.
- To see if a company has a durable advantage, go to the balance sheet. What do they have in assets, cash and property?

- How much debt are they carrying?
- The balance sheet is only a snapshot of the company's financial condition at the time the balance sheet is generated.
- Assets & Liabilities
- **Liabilities:**
 1. current and which is owed within a year
 2. Long-term, debt owed one year or more
- Asset minus liabilities = the net worth or the corp. or shareholders equity.
- Assets – as a rule, they are listed on the balance sheet in order of their liquidity.
- Current/working assets – can be converted into cash within a year
- All other assets that aren't current cannot be converted into cash within one year.
- The cycle of cash –
 1. buy your inventory or pay for services
 2. Sell the goods or services
 3. This becomes Accounts Receivable
 4. Accounts receivable when collected converts back to cash
 5. How long is this cycle, how good are your receivables?
- If a corp. has a lot of cash:
 1. The corp. has a competitive advantage that generates tons of cash.
 2. or that sold a business or asset which may not be a good thing.
- A company has three ways of creating a large stock pile of cash:
 1. It can sell new bonds or equity to the public. This creates cash before it is put into use.
 2. It can sell existing assets and then deploy the cash.
 3. Or it has an ongoing business that generates more cash than the business burns.

The Warren Buffet Rule – If you have lots of cash and marketable securities and little or no debt, chances are very good that your business will sail on through troubled times.

- As simple test to see exactly what is creating all the cash is to look at the past seven years of the balance sheets.
- This will reveal whether the cash hoard was created by a one-time event or if it was created by ongoing business operations.

- The ideal corp. – Lots of cash, low debt, no sales of shares or assets, a history of consistent earnings, this is a good company to buy.

Inventory – Depreciating, obsolete inventory must be replaced someday. Set up a sinking fund or find other creative ways of financing their replacement.

Net receivables – Receivables less bad debt = net receivables

- Producing a consistent product or service that does not need to change equates to consistent profits.
- Add current assets to long term assets = total assets
- Total assets will match total liabilities plus shareholders equity. They balance with each other, which is why it is called a balance sheet.
- **Accrued expenses** – liabilities that have been incurred, but has yet to be invoiced for
- **Long term debt** – debt that matures over one year
- **Share buy backs:**
 1. It can cancel them.
 2. Retain them with the possibility of reissuing them later on. They are then carried on the balance sheet as shareholders equity as treasury stock. No dividends are paid to these shares.
 3. Cash flows out of the company.
 4. This reduces the number of shares outstanding which increases the shareholder value, increases the per-share earnings which eventually makes the stock price go up.
- **Accrual method of accounting** – sales are booked when the goods go out the door, even if the buyer has not paid for them.
- **Cash method** – sales are only booked when the cash comes in.
- **Cash flow statement** – positive or negative cash flow. They are like the income statements. Usually produced every three months.
- When to sell good shares:
 1. When you need money to buy an even better business.
 2. When the business starts to lose its durable competitive advantage.
 3. During bull markets. Sell at the top.
 4. When P/E Ratio is 40 or more.

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