

## **Warren Buffett and the Interpretation of Financial Statements, The search for the Company with a Durable Competitive Advantage**

By Mary Buffet and David Clark  
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Years ago, investing was left to the professionals. Solid investment strategies took large teams of financial analysts and accountants years to implement. However, in today's ever improving technology driven culture, a single person could implement these strategies with just a click of a button. A tech-savvy investor can run a regression analysis, which at one point might have taken that previously mentioned team of professionals a month, in ten minutes or less. What has changed? The simplest, and most general answer, is technology; and Warren Buffet utilizes this technology in every aspect of his investments.

Warren Buffet is one of the best and most well known investors in the world and the strategies that got him where he is today are nothing short of genius. These investment strategies, derived from Benjamin Graham's value investing, disrupt conventional investing maxims like the greater the risk the greater the potential return.<sup>1</sup> Searching for a durable competitive advantage diminishes potential risk without diminishing returns, and maintaining long-term investments eliminates costly capital gains tax. But what is truly amazing Warren Buffet's ability to continuously stay ahead of the curve and identify the durable competitive advantage quickly and correctly.

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<sup>1</sup> See, <http://www.investopedia.com/university/greatest/benjaminraham.asp> (Describing Benjamin Graham as the father of Value Investing)

In this book, the authors seek to identify how Warren Buffet goes about identifying which companies are most suitable to his trading strategy. Buffet and Clark outline the entire process, from locating and researching a verity of financial documents, to the final sale of the stock. Their detailed discussion of the process includes insight into the implementation of Warren's investment strategy, and although the book has a straightforward approach, it requires a general background understanding of both finance and accounting.

All publicly traded companies must file quarterly financial statements with the SEC. These quarterly reports, called 8Q's, are made available to the public via the internet. Specifically these reports are available at Yahoo Finance, which is the website I have used myself for many years.<sup>2</sup> Utilizing this free and easily accessible financial information is the key to Warren's investment strategy. With this understanding, the authors break down each financial document and how to interpret and understand it. The most amazing part of these websites is the technology available; comparing financial statements, running regression analysis, and analyzing corporate expenditures is can be done with the touch of a button.

The Income Statement – The authors describe Warren's approach to utilizing the income statement. Looking for a durable competitive advantage through the income statement is a fairly difficult process. It involves determining whether or not money is being spent in all the correct places. One must determine not only how a particular company, in a particular industry spends money but also how a company such as this one should spend in this particular industry. Warren Buffet achieves this through painstaking analysis of every modicum of information given in the income statement.

The Balance Sheet – The basic formula is simple enough:  $Assets = Liabilities + Equity$ . The question is how are liabilities and equity are advantageous, and how can assets be a drain on

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<sup>2</sup> [www.finance.yahoo.com](http://www.finance.yahoo.com)

the company. The authors demonstrate how Warren Buffet has come to interpret each aspect of the balance sheet. First what assets are appropriate, how much cash is on hand, what type of inventory conversion cycle is being employed and how much credit the company tends to extend. Second what liabilities the company has incurred, both short term and long term debt can have devastating effects on a company if they are not managed correctly. Finally the authors detail how Warren's strategy dissects equity. Above average retained earnings or purchased treasury stock are an indicator of a financially healthy corporation. The authors indicate that the balance sheet should present a clean bill of health for any good investment.

The Cash Flow Statement – The cash flow statement provides the answer to a simple question; how much capital does a corporation require? The authors present three categories of cash flow, the first being cash flow generated from operating activities. Operating activities are simple to understand, and can be summarized as net income after depreciation and amortization. The second category is cash flow generated from investing operations. Here Warren seeks out the most favorable ration of capital expenditures to investing income. The authors describe in great detail how too much capital expenditure can wreak havoc on what otherwise appears a good investment. The third and final category is cash flow generated from financing activities; financing activities simply illustrate how a company raises money to pay for its processes. The cash flow statement details the inner-workings of any corporation, and if used correctly can help to diagnose a problem before it is too late.

*Warren Buffett and the Interpretation of Financial Statements, The search for the Company with a Durable Competitive Advantage*, is recommended to people who have a general background understanding of finance and accounting, and want to educate themselves on some of the details Warren Buffet's investing strategies. I would not recommend this book to someone

who is new to investing, or has never taken a business finance class. Warren's novel and often counter intuitive approach to investing should open the mind of business savvy investor.