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Warren Buffett and the Interpretation of Financial Statements: The Search for the Company with a Durable Competitive Advantage by Mary Buffett and David Clark, Simon and Schuster UK Limited, 2011, 12 pages, £ 8.99, ISBN 978-1-84983-319-6

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Mary Buffett, an international bestselling author and a renowned speaker on Investments Methodology founded by Warren Buffett is one of the famous personalities in the modern days of investment. She is the daughter in law of Warren Buffett.

David Clark is a Buffettologist and a managing partner of a private investment group in Omaha, Nebraska. He is a co-author of Mary Buffett and together they have written four bestselling books on investment methods by Warren Buffett.

The book is a literary milestone in the field of Value Investment. The book is a kind of notebook by Warren Buffett, edited by authors providing examples and explanatory notes in the required areas. The book aims to provide knowledge regarding theoretical and practical ways to interpret and make the right investment.

The first unit contains introductory and historical background on the evolution of 'Value Investment'. The authors present a comparative analysis between the strategy of Warren Buffett and Benjamin Graham. They explain how Warren Buffett made further development (or alteration) of the knowledge discovered by his mentor Benjamin Graham. Warren Buffett has established certain facts in order to identify valuable companies with a durable competitive advantage. They explain how basing on Graham's methodology of 'bond analysis techniques' and '50% rule' Warren Buffett states that it's not the price of shares that keep on fluctuating (and their purchase and sell in lower and higher prices respectively) but the durability of a company which gives competitive advantage to investors in the long run. As per Warren Buffett the durability of a company depends on producing unique products or unique services that public need consistently. The "durable competitive advantage" of a company can be found after going through its financial statements and hidden information can also be analyzed by going through the statements.

The second unit of the book deals with Income Statement. The authors have mentioned how Warren Buffett investigates for a company with durable competitive advantage with the help of income statement of the company. They have focused on discussing income statement highlighting the strategies followed by Warren Buffett. Huge amount of revenue does not mean a company has capacity of earning profit; expenses have to be subtracted from it in order to get the actual amount of net profit or loss. The secret of earning more money is by spending less of it. The authors discuss how cost of goods sold

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(Cost of Revenue) determines gross profit of a company. They mention, Warren would prefer the lower cost of goods sold as gross profit would be affected and for him the better gross profit margin of a company is a key factor for long term benefit. As a keen observer he kept vigil on operating expenses of companies. The company with lower Selling, General and Administrative (SGA) Expenses would have durability in the market and preferable to investors. Warren avoided companies with high R&D spending as he believed companies with technological advantage would always surpass each other in technological development. Further, depreciation cannot be ignored as it is a charge against gross profit and the rate of depreciation should be considered. He observed companies having lower rate of depreciation to be "durable". He noticed, company with lower ratio of interest expense to operating income have competitive durable advantage. Warren believed that a company's capital gain or loss should not be taken into account for the calculation of net earnings as it has nothing to do with durability of a company. He emphasizes on pre-tax terms while reading the earnings of a company. According to him investors through open market can purchase shares of a company and remain free from the burden of tax. He cautions about companies that claim to pay tax. In the long run companies are actually earning more than what they show to the public and shareholders may be misguided due to false tax payments. Warren arrives at the net earnings of a company after all the deductions and this is what the investors want to know from a company. It should be noted that historical trend of net earnings may vary from the current trend depending on market value of shares. Higher rate of stock price means higher per share earnings of a company. Warren chooses the right company by analyzing the company's earnings per share for the past ten years.

The third unit speaks of analysing balance sheet in order to find a company with "durable advantage". He knows that balance sheet reveals the historical cost of both assets and liabilities. He tells us how current assets is closely associated with business cycle and are convertible to cash and near cash assets (cash equivalents) in due course of time. He closely observed cash and cash equivalents as cash is the solution and remedy for hard times. The higher ratio of cash and cash equivalents to debts is a good indicator for investors. Warren looks for inventory and net earnings with a rising trend. As inventory with passage of time depreciates and lose its value, he prefers manufacturing companies selling unique product or providing unique services with durable advantage. A company with consistent lower ratio of net receivables to gross sales is also an indicator of competitive advantage durability. Prepaid expenses (Deferred Revenue Expenditure) tell little about the durability of a company. Using ratio analysis Warren observed that some companies with their current ratio less than one have durable advantage. It is the earning power (Capacity) of a company which helps it to overcome bad market situations covering their current liabilities. Hence, current ratio for Warren is a useless tool. He further states that a company with durable advantage does not have to change (or upgrade) its assets in order to compete in the market but sell products used by consumers consistently. Warren again noticed that a company with increasing goodwill has durable competitive advantage.

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Warren saw the consistency of product (or service) and net earning power to make him super rich with the world watching. Long-term investment is also a factor for Warren's success. Warren contradicts with analysts that higher return on asset ratio (Net Earnings ÷ Total Assets) may indicate suspicion of competitive durability of a company in the long run. Current liability of a company can be of great help in knowing the durable economy of a company in the market. Short-term debts of a company can be decisive sometimes as per market situations. The borrowings made by the company may have to be paid earlier than the stipulated time; payment of such borrowings drains cash weakening a company's financial health. Warren stays away from companies with huge borrowings. Long term debts of a company may be troublesome for investors as some companies write their long-term debts with short-term debts which are to be paid off. Paying off such long-term debts affects cash flow of a company which is a feature of durable company. Shareholders' equity ratio can be useful for finding right company; and for Warren, retained earnings (a part of Shareholders' Total Equity) is a secret for becoming rich. Warren noticed that presence of treasury stock in the balance sheet and history of buy back of shares indicates company possessing durable competitive advantage. High return on shareholders' equity for Warren is an invitation to invest in a company whereas he stays away from the companies which use leverage to generate earnings.

The fourth unit deals with cash flow statement which consists of three sections: cash flow/used from/in operating activities; cash flow/used from/in investing activities and cash flow/used from/in financing activities. This unit is left to the readers to find out what Warren wanted from cash flow statement as he himself has emphasized on careful study of three sections of it. However, Warren discovered that a company having less capital expenditure is a company with durable competitive advantage. He observed companies which buy back shares eventually increase shareholders' interest and earnings per share of a company.

The last unit is conclusive and appealing to the readers where the authors have mentioned about the talk s given by Warren Buffett at Columbia University in the late 1980s. The authors have mentioned the names of some companies where Warren had invested to become super rich in his time. He watched carefully for coupon/interest payment (company's pretax earnings) which is one of his secrets. He observed that earning per share of a company increases with time and is fruitful in the long run. Warren was able to see the possibility of evading tax even while holding shares which may value for millions. He also noted that good buying opportunity is when the price of a company's share is low. Warren would never sell a company's share until it has durable competitive advantage in selling. However, sometimes even after having quality in a company investors may need immediate cash and may get better price option and sell the shares. For Warren, secret lies in holding the shares of a company because he does not want to involve a taxman during sale of shares.

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The book provides a comprehensive guide to both investors and readers (academic and professionals); it is also helpful for beginners. The book is lucid and plain for even a layman to understand what interpretation of financial statements is all about. The book appeals readers to explore the world of value investment on their own. However, the strategies followed by Warren Buffett may not be applicable to everyone and every nation. Therefore, a comprehensive study of accounting principles of the country is required along with taxation, stock market trend, political and economic policies. There are various tools that can be applicable for measuring durability of a company but Warren didn't use them all. He interpreted financial statements as per his intelligence, skill and experience but he emphasized on understanding accounting. It will be better to summarize in his words – "You have to understand accounting and you have to understand the nuances of accounting. It's the language of business and it's an imperfect language, but unless you are willing to put in the effort to learn accounting – how to read and interpret financial statements – you really shouldn't select stocks yourself."