Book Review: Warren Buffett Accounting Book:
Reading Financial Statements for Value Investing

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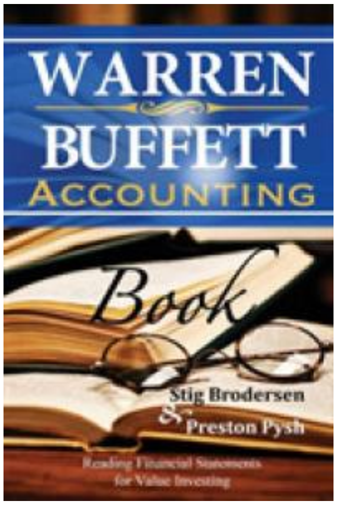

Book Title: Warren Buffett Accounting Book: Reading Financial Statements for Value Investing
Author: Stig Brodersen and Preston Pysh
Publication Date: 2017
Publisher: Se-Education Public Company Limited
ISBN: 9786160845699

If you are one of those people who are interested in the world of investment, you might have already known that investment strategies can be divided into two main categories which are technical or active investing, and value or passive investing. Normally, a value investing strategy is defined as an investment strategy that involves effective selection of equity securities that appear to have market prices less than their intrinsic values as much as possible. (Hayes, 2022) In Warren Buffett Accounting Book, the authors analyze and clarify the way Warren Buffett always uses when he wants to choose a proper stock to buy. It is certain that Warren Buffett has some vital tactics for management and investment that make his Berkshire Hathaway Inc. become one of the largest companies, based on market capitalization, in the world. In sum, Buffett's investment philosophy mainly focuses on purchasing companies' ordinary shares at the lowest price or at the point that has the highest margin of safety but still has the possibility to make money in the long run. Generally, Buffett chooses fundamentally strong companies by assessing companies' background and their key basic financial data such as Return on Equity (ROE) and the growth of dividend payout. If you are a value investor and want to follow Warren Buffett's footsteps, this book will at least give you a way or two to succeed in selecting appropriate companies to invest.

This book consists of eight chapters. It starts with Chapter 1: How to understand stock market and follows by Chapter 2: General concepts that investors should know, Chapter 3: Basic explanation about the financial statements, Chapter 4: Principles and rules of value investment, Chapter 5: Financial statements and investors who invest in equity securities, Chapter 6: In depth into financial statements, Chapter 7: In depth into Statement of

Financial Position, and Chapter 8: In depth into Statement of Cash Flows. Specifically, in Chapter 1, the authors point out that if you are a value investor, you must concentrate on companies in the long term, not their current stock prices. Because the changes in market prices of stock are not consistent with any fundamental or logic, it is important for investors to be more careful and take this fact into consideration when buying or selling stocks. In real life, plenty of investors invest based on emotion. Contradiction to Buffett's investment philosophy, it is obvious that either greed or fear is one of the reasons why so many investors buy stocks at market tops, while selling them at market bottoms. Moreover, in this chapter, the authors also identify the major difference between a stock price and an intrinsic value of a stock that is very crucial knowledge for investment decision making for all value investors. In Chapter 2, the authors explain some key concepts and close relationships among interest rates, inflation rates and government or corporate bonds. In terms of interest rates and inflation, it is essential for value investors to realize that interest rates, inflation, and monetary policies by central banks around the world, have huge impacts on companies' intrinsic values and rate of returns for investors. In the end of the chapter, the authors suggest that investors should invest in government or corporate bonds only in the time of high interest rate and low inflation rate, whereas investing in stock market is more suitable in any other situation.

Next, because value investing needs both companies' background and financial information for analyzing and choosing some valuable companies, that is why the authors start to provide some basic knowledge about financial statements in Chapter 3. Financial statements presented in Chapter 3 comprise Income Statement, Statement of Financial Position and Statement of Cash Flows. Details in each statement such as revenue, cost of sales, gross profit, selling and administrative expenses and net income for Income Statement, assets, liabilities, and shareholders' equity for Statement of Financial Position, and cash flows from operating activities, cash flows from investing activities and cash flows from financing activities for Statement of Cash Flows, are roughly shown to give some rudimentary understandings to inexperienced investors. In Chapter 4, the authors move to the real conceptualization of Warren Buffett's value investing. They point out that Warren Buffett always holds on to the four principles when choosing to invest in a company. The four principles include: (1) selecting a promising company with a prudent leader who can manage his company to have low level of debt, high level of working capital, high and consistent ROE, and appropriate management compensations; (2) selecting a promising company with excellent prospects for sustainable products and lowest payment of corporate income tax in the long run; (3) investing in low volatility and understandable companies' stocks with consistent growth of book value, and sustainable competitive advantages; and (4) purchasing stocks at attractive prices which mean the prices with high level of margin of safety (intrinsic value much higher than market price), low Price-to Earnings (P/E) ratio and low Price-to-Book (P/B) ratio, as well as identifying proper discount rate and selling stocks at the right time. To estimate the margin of safety, the authors thoroughly explain two methods for calculating an intrinsic value of a company which are Discount Cash Flow (DCF) method and Buffett's method. In short, an intrinsic value from the DCF method is calculated by discounting expected free cash flow up to infinity with the proper discount rate, while the Buffett-book method uses book value, dividend, percentage change per year of the book value, and discount rate to calculate company's intrinsic value up to only 10 years. In the end of the chapter, the authors also indicate that there are some limitations when calculating intrinsic value using the Buffett-book method. The limitations are for those companies that do not follow the four principles of Warren Buffett, or companies with high book value growth, a large amount of stock buybacks, and history of stock splits. After that, for Chapter 5 to Chapter 8, the authors explain in more detail about double-entry bookkeeping, the difference between cash basis and accrual basis, the top three financial statements, and some most popular financial ratios such as gross profit margin ratio, operating margin ratio, net profit margin ratio and interest coverage ratio for Income Statement, ROE, Return on Assets (ROA), current ratio, quick ratio, inventory turnover, accounts receivable turnover, accounts payable turnover, Debt-to-Equity (D/E) ratio and liabilities-to-equity ratio for Statement of Financial Position, and free cash flow-to-sales ratio, cash flow from investing activities-to-cash flow from operating activities ratio for Statement of Cash Flows.

In conclusion, this book provides us with some insights into the value investing strategy used by Warren Buffett, the investing wizard of Omaha. In my opinion, the parts that explain about value investing and calculation of intrinsic value either from DCF model or Buffett-book model are good enough. It provides sufficient details and explanations that are necessary for the best estimation of companies' intrinsic value. However, the parts that explain some basic knowledge of accounting and financial statements are a bit too rough to help unsophisticated readers clearly understand the complexity and the complicatedness of listed companies' financial statements. Some important issues that all unsophisticated readers should be aware of when reading this book or when applying this knowledge into the real world are as follows:

(1) Income Statement presented in this book is only shown as a multiple-step statement. However, as stated in International Accounting Standard (IAS) 1: Presentation of Financial Statements, a company can choose either a single-step or multiple-step Income Statement and can choose to classify expenses either by nature or by function.

(2) In fact, all listed companies must present a Statement of Comprehensive Income, not an Income Statement, and as stated in IAS 1, a company can choose to present the Statement of Comprehensive Income as a single continuous statement or two separate but consecutive statements.

Moreover, if you read this book in Thai version, I would like to advise you to check formulas of financial ratios from other sources before using them because some of them are not correct.

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