

AI-01915 Checklist-Reading Company Reports

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Warren Buffett reads financial reports regularly, what are the items he is looking closely.

Warren Buffett is known for his disciplined and methodical approach to investing, which is heavily based on a thorough analysis of financial statements. His philosophy, influenced by his mentor Benjamin Graham, focuses on finding companies with a durable competitive advantage (a "moat") at a reasonable price. He looks for businesses that are understandable, have a consistent operating history, and favorable long-term prospects.

When he reads a financial report, he's not just skimming for a few numbers. He's trying to understand the business from the inside out, looking for specific clues that indicate a high-quality company. His primary focus is on the long-term fundamentals and the true economics of the business, rather than short-term fluctuations or complex accounting gimmicks.

Here are the key items Warren Buffett looks at closely in financial reports:

Income Statement

1. **Gross Profit Margin:** Buffett looks for companies with high and consistent gross profit margins. A high margin (often above 40%) suggests the company has pricing power and a strong competitive advantage, meaning it's not competing purely on price.
2. **Operating Expenses (SG&A):** He examines selling, general, and administrative expenses. A company with a strong moat doesn't need to spend an excessive

amount on overhead to maintain its operations. He looks for a stable or declining ratio of SG&A to gross profit.

3. Research & Development (R&D) and Depreciation: Buffett is generally wary of companies that require high R&D or capital expenditures (depreciation) to stay competitive. He prefers businesses that generate strong cash flow without having to constantly reinvest a large portion of it back into the company just to maintain their position.
4. Net Income and Profitability: He wants to see a consistent and growing net income over time. A high net margin (often 20% or more) indicates a company that is very efficient at converting revenue into profit.

Balance Sheet

5. Debt: This is a crucial area for Buffett. He seeks companies with little to no debt. He prefers businesses that are financed with equity, not borrowed money, and that have more cash than debt on their balance sheet. Excessive debt can make a company vulnerable, especially during economic downturns.
 6. Retained Earnings: Buffett pays close attention to how a company uses its retained earnings. He looks for evidence that the management is allocating capital effectively and creating at least one dollar of market value for every dollar of earnings retained.
 7. Inventory and Receivables: He examines inventory levels and accounts receivable. A high-quality business should be able to manage its inventory efficiently and collect its receivables in a timely manner.
 8. Owner's Equity: He focuses on the growth of shareholder equity and the return on that equity (ROE), which he considers a key measure of profitability.
- #### Cash Flow Statement
9. Operating Cash Flow: Buffett wants to see a consistent and strong positive cash flow from operations. This shows the business is generating real money from its core activities.
 10. Capital Expenditures (CapEx): He looks for companies with low capital expenditure requirements. A business that doesn't need to spend a lot of money on property, plant, and equipment is a sign of a great business with a durable competitive advantage.

11. Free Cash Flow: Ultimately, he's focused on free cash flow, which is the cash a company generates after accounting for the money it needs to maintain or expand its asset base. This is the "owner's earnings" that can be used for things like dividends, share buybacks, or future investments.
12. SG&A stands for Selling, General, and Administrative expenses. It's a crucial line item on a company's income statement that represents all the non-production costs of running a business. Essentially, it's a broad category for the day-to-day operating expenses that aren't directly tied to creating a product or service. Here's a breakdown of what each part typically includes:
 - Selling Expenses: These are costs directly related to selling and marketing products or services. Examples include advertising, marketing campaigns, sales commissions, and travel expenses for the sales team.
 - General Expenses: These are the costs of general operations and administration. Think of things like rent, utilities, insurance, and office supplies.
 - Administrative Expenses: This includes the costs of managing the business as a whole. Examples are the salaries of executives, accounting staff, and human resources personnel, as well as legal and consulting fees.

Warren Buffett's Financial Report Checklist

Here is a list of the key items Warren Buffett looks for in financial reports, presented as a non-tabulated checklist:

Income Statement

1. Gross Profit Margin: Buffett looks for companies with a high and consistent gross profit margin, which suggests the company has pricing power and a strong competitive advantage.
2. Operating Expenses (SG&A): He examines the selling, general, and administrative expenses, seeking a stable or declining ratio of these expenses to gross profit, which indicates an efficient operation.
3. R&D and Depreciation: He is wary of businesses that require heavy spending on research and development or significant capital expenditures (represented

by depreciation) to maintain their competitive position.

4. Net Income and Profitability: He seeks companies with a consistent and growing net income and a high net profit margin over a long period.
5. Interest Expense: He looks for businesses with minimal interest expense, preferring companies with little to no debt.

Balance Sheet

1. Debt: A critical focus for Buffett is a company's debt levels. He prefers companies with very little or no debt, and ideally, more cash than debt on the balance sheet.
2. Retained Earnings: He analyzes how management uses retained earnings, looking for evidence that each dollar of retained earnings has created at least one dollar of market value.
3. Inventory and Receivables: He checks if inventory levels are efficiently managed and if accounts receivable are collected in a timely manner, which are signs of a healthy business.
4. Return on Equity (ROE): He considers a consistently high return on equity to be a key measure of a company's profitability and competitive strength.
5. Total Assets: He looks for steady growth in total assets, which can indicate business expansion and health.

Cash Flow Statement

1. Cash Flow from Operations: Buffett wants to see strong, consistent, and positive cash flow generated from the company's core business activities.
2. Capital Expenditures (CapEx): He seeks companies with low capital expenditure requirements, as this indicates a business with a durable advantage that doesn't need constant reinvestment.
3. Free Cash Flow: He focuses on a company's free cash flow—the "owner's earnings"—which is the cash left over after all expenses and capital expenditures, and which can be used to benefit shareholders.

Overall Business Assessment

1. Business Understandability: Buffett only invests in companies whose business he can fully understand.
2. Consistency: He looks for a long and consistent operating history with stable financial performance.
3. Moat (Competitive Advantage): He seeks a durable competitive advantage that protects the company from competitors and ensures long-term profitability.
4. Management Integrity: He values honest and rational management that is good at allocating capital and whose interests are aligned with those of shareholders.