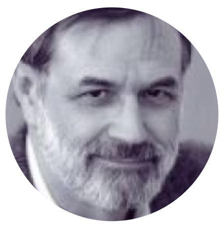

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Buffett on Financial Statements: Balance Sheet Liabilities

A closer look at the relationship between debt and durable competitive advantage

April 16, 2019 | About: WFC +0% BAC +0% GM +0% F +0% MCO +0% BRK.A +0% BRK.B +0% KO +0%

After dealing with the income statement and balance sheet assets in their book, “Warren Buffett and the Interpretation of Financial Statements: The Search for the Company with a Durable Competitive Advantage,” authors Mary Buffett and David Clark turned to the liabilities side of the balance sheet.

That current liabilities section of the statement looks like this:

Balance Sheet/Liabilities

($ in millions)

Accounts Payable	$1,380
Accrued Expenses	5,535
Short-Term Debt	5,919
Long-Term Debt Due	133
Other Current Liabilities	258
Total Current Liabilities	$13,225

“Current” refers to debts and other obligations that must be met within the fiscal year.

Again, the authors were looking at them as a tool for discovering durable competitive advantages. Such moat-like qualities are found in some line items:

Accounts payable and accrued expenses

This category covers what a company owes its suppliers for raw materials, inventory and the like. In other words, the goods have been delivered, but the bill, or a portion of it, has yet to be paid. Accrued expenses refers to liabilities created but not yet paid; they include sales taxes, wages and rent payments. This category also includes “other debts” that cover short-term liabilities that don’t fit into the other two categories. Generally, Warren Buffett (Trades, Portfolio) does not see much beyond numbers here.

Short-term debt

Including commercial paper and short-term debt, this line item refers to obligations due within one year. For financial firms, there is always the opportunity to leverage the difference between short-term and long-term debt: Borrow short term at say 5% and lend long term at 7%. But it did not work out so well for Bear Stearns and thousands of lesser-known companies throughout financial history. It also explains why Buffett likes Wells Fargo (NYSE:WFC), which had 57 cents of short-term loans for every dollar of long-term debt, compared to Bank of America (NYSE:BAC), which had $2.09 at the time of publication. Wells Fargo is far more conservative than Bank of America, and much more likely to survive a downturn.

Long-term debt due

This is the portion of a long-term debt that becomes due each year. Buffett expects companies with a durable competitive advantage, a moat, will need little or no long-term debt to maintain or grow their operations. All investors should be concerned about companies that include current long-term debt commitments with their short-term debt. Beware, too, of too much long-term debt coming due in a single year.

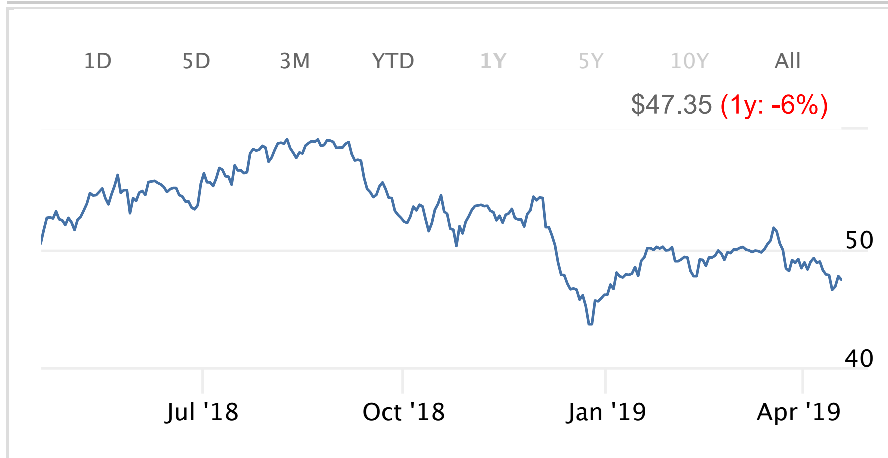
Other current liabilities

The authors wrote nothing for this section, but usually it refers to liabilities that do not fit into the categories above, but like them are due in the next year. Presumably, Buffett does not see any insights arising out of this section.

Total current liabilities and the current ratio

Total current liabilities is the total of all the short-term obligations and the portion of long-term debt coming due in the next year.

The authors focus on the current ratio, which provides an indication of a company’s liquidity. It is calculated by dividing total current assets by total current liabilities; a ratio of more than one is a good sign, while a ratio of less than one suggests a company may have trouble meetings its



financial obligations.

Yet many companies with durable competitive advantages have current ratios of less than one. Why? Because these companies have “immense” earnings power and usually don’t require the same “liquidity cushion” as marginal or average businesses. So we should not expect the current ratio to give us reliable indications about a company’s moat.

That covers current liabilities, but, of course, there are also non-current liabilities that must be recognized on the balance sheet:

Balance Sheet/Liabilities

($ in millions)

Total Current Liabilities	$13,225
→ Long-Term Debt	3,277
Deferred Income Tax	1,890
Minority Interest	0
Other Liabilities	3,133
Total Liabilities	$21,525

Long-term debt

This refers to obligations due more than a year ahead, and is a category Buffett takes very seriously. The type of companies he looks for, with durable competitive advantages, usually have little or no long-term debt. They generate earnings that are more than enough to self-finance their expansions, acquisitions, buybacks or dividends.

Consider these comparisons: strong-moat companies Coca-Cola (NYSE:KO) and Moody’s (NYSE:MCO) could, at the time of publication, pay off their long-term debt in a single year. On the other hand, automakers and no-moat companies General Motors (NYSE:GM) and Ford (NYSE:F) would need more than 10 years to pay off their high levels of long-term debt. We know where Buffett has invested his money, which is to say that of Berkshire Hathaway (NYSE:BRK.A) (NYSE:BRK.B).

Deferred income tax, minority interest and other liabilities

These are the last three lines in the long-term section of liabilities. Deferred income tax is relatively straightforward and provides little information about durable competitive advantages.

The minority interest line is a complex one: For example, when Berkshire Hathaway bought Nebraska Furniture Mart, it acquired 90% of the shares. According to accounting rules, though, Berkshire could book 100% of Nebraska Furniture Mart’s income on its balance sheet, along with the assets and liabilities. Minority interest on the balance sheet reflects the 10% of Nebraska Furniture Mart that Berkshire did not buy.

Other liabilities may include obligations such as judgements against the company, non-current benefits and derivatives. Again, there is no help in identifying durable competitive advantages.

Total liabilities and the debt-to-equity ratio

Total liabilities is the sum of current and non-current liabilities, essentially everything a company owes from tomorrow until years into the future.

It also provides data for the debt-to-(shareholders’) equity ratio. Typically, it was used to help figure out whether a company was using debt or equity to finance its operations. In theory, at least, companies with a durable competitive advantage will have enough earnings power for their operations and expansion so they have little need for debt and other liabilities. But once again, companies with strong moats defy the meaning of the debt-to-equity ratio. Given their earnings power, they need little or no equity (or retained earnings) on their balance sheet. Instead, they can buy back shares, make acquisitions or issue dividends with their earnings.

For example, at the time of publication, Moody's, a company with a durable competitive advantage, required no shareholders' equity on its books, so it used that cash to buy back shares. And it bought back so many shares it had negative shareholders' equity. That meant its debt-to-equity ratio looked like that of General Motors, which has no durable competitive advantage.

Once again, financial institutions are an outlier since they are in the business of borrowing and lending money.

As with the income statement and assets section of the balance sheet, Buffett uses the liabilities section to help find outstanding companies with durable competitive advantages.

Disclosure: I do not own shares in any company listed, and do not expect to buy any in the next 72 hours.

Read more here:

- Buffett on Financial Statements: Balance Sheet Assets
- Buffett on Financial Statements: The Income Statement
- Buffett on Financial Statements: A Window Into Warren's Mind

About the author:

Robert Abbott

Robert F. Abbott has been investing his family's accounts since 1995 and in 2010 added options -- mainly covered calls and collars with long stocks.

He is a freelance writer, and his projects include a website that provides information for new and intermediate-level mutual fund investors (whatisamutualfund.com).

As a writer and publisher, Abbott also explores how the middle class has come to own big business through pension funds and mutual funds, what management guru Peter Drucker called the "unseen revolution." In his book, "Big Macs & Our Pensions: Who Gets McDonald's Profits?" he looks at the ownership of McDonald's and what it means for middle-class retirement income.

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