Does Warren Buffett Not Understand the Meaning of Profit?

Prof. Alvaro Guimarães de Oliveira

Rio, 09/02/2018.

The more I specialize in the philosophy and logic of accounting, the more I realize that accounting scientists (creators of norms, resolutions, and accounting laws) demonstrate that they have superficial knowledge of accounting.

This affirmation is founded on my realization that accounting, today, is fraught with errors.

With so many examples, let us cite only the following:

1) The main one, which I call the "original sin of accounting," is the mistake that exists in the Double Entry Theory, which upon being developed marked the beginning of accounting as a science: the accounting sciences.

   That every debit corresponds to a credit of equal amount – as double entry bookkeeping says – there is no doubt. But to relate the assets of a company to debit accounts and the liabilities to credit accounts is an abysmal mistake, does not make any sense, and does not even satisfy accounting philosophy at all.

2) Law 6,404 of 1976-12-15, despite the great contributions that it brought to our accounting practices, incorrectly classified Prepaid Expenses in the Current Assets group.

   It is inconceivable that an expense be classified as an asset, and escapes all accounting logic.

3) Law 11,638 of 2007, which modified Law 6,404, introduced a huge mistake: it substituted the Statement of Changes in Financial Position with the Cash Flow Statement (DFC).

   The former is the best financial statement that exists for understanding the financial situation of a company in the short term.

   The latter, the Cash Flow Statement, is an excrescence, an accounting farce. It is totally useless, and even worse, it causes one to mistakenly think that profit is money.

   Anyone with reasonable knowledge of accounting philosophy would never create such a monster.

WARREN BUFFETT'S MISTAKES

The millionaire Warren Buffett, who is one of the richest men in the world – second only to Bill Gates –, made his fortune analyzing company financial statements with the aims of: buying shares in stock markets, acquiring equity stakes, and acquiring companies completely.

As a result of his unmatched success, he is considered an extraordinary analyst of financial statements, and obviously, a real expert in accounting. Of course, one cannot be a financial statement analyst of his calibre without knowing accounting philosophy as if it were the palm of his hand.

I recently acquired a book – *Warren Buffett and the Interpretation of Financial Statements* – written by Mary Buffett and David Clark, who are recognized authorities in Warren Buffett's investment methods. Mary Buffett is also the billionaire's former daughter-in-law.

The theme of the book is based on what Warren Buffett has said or done in relation to his conclusions and affirmations about financial statement interpretation.

That being the case, I consider that Warren Buffett is responsible for the hits and misses found in this book.

FIRST MISTAKE FOUND

In Chapter 4, on page 23, we found the following interpretation: "The income statement tells us how much money the company earned during a set period of time."

This interpretation, despite being that of most professionals who deal with accounting, including accountants, is incorrect. *The Income Statement records, during the fiscal period, the changes made in the book value of the company – net worth – by its economic activities*.

Therefore, the profit or loss has nothing to do with cash or money, but with the book value of the company.

Let us work with a very simple example to completely clarify our position:

AGO
2016-12-31

Cash	10,000	Suppliers	30,000
Inventory	25,000	Net Worth	17,000
Equipment	12,000	Capital	17,000
		Profit	0
Total	47,000	Total	47,000

Let us suppose that during January of 2017 all the Inventory was sold for 35,000 to be received in April. January's salary totaled 1,500, but will only be paid in February. And the depreciation rate of equipment is 10% per year. Therefore, the depreciation expense, in January, was 100.

With this information at hand, what was this company's income in January?

Financial position of AGO on 2017-01-31:

AGO
2017-01-31

Cash	10,000	Suppliers	30,000
Accounts Receivable	35,000	Salaries Payable	1,500
Inventory	0	Net Worth	25,040
Equipment	12,000	Capital	17,000
Accumulated Depreciation	(100)	Profit	8,400
Total	56,900	Total	56,900

Income Statement

Revenues	35,000
COGS	(25,000)
Gross Profit	10,000
Salary	(1,500)
Depreciation	(100)
Profit	8,400

Despite the clear profit of 8,400, the cash of AGO did not change, which totally justifies our interpretation of profit.

Just to confirm, let us observe that the initial net worth was 17,000 and now it is 25,400, that is, the difference is the profit coming from the economic activities of AGO: 8,400.

If the profit is not cash, where is it? It is in the Working Capital of the company. We might say that the adjusted profit for the period, when there are not even accounts receivable or payable, in the long-term, is precisely the increase in the working capital for the period.

Proof

	2016-12-31	2017-01-31
Cash	10,000	10,000
Accounts Receivable	-	35,000
Inventory	25,000	-
Suppliers	(30,000)	(30,000)

Salaries Payable	0	(1,500)
Working Capital	5,000	13,500

Profit for the period	8,400
+ Depreciation	100
Adjusted profit for the period	8,500

And once more, we can see that profit has nothing to do with cash or money.

The Adjustment of the Depreciation Expense

The adjustment of depreciation (reversing entry) to determine the total amount of resources coming from the economic activities that affected the working capital is correct, because in the calculation of net income, the depreciation expense was considered as an expense, and it is, but it does not affect the amount of working capital. The depreciation expense affects the Fixed Assets, but not the working capital, which is equal to the Current Assets minus the Current Liabilities. The latter is, in fact, the only reason for the adjustment considered.

In general, it is a senseless mistake to consider that the reason for the adjustment is that the depreciation expense does not mean cash outflow.

So why does the adjustment not contemplate the Provision for Doubtful Debts expense, which just like the depreciation expense, does not mean cash outflow? Simply because this expense, unlike depreciation, affects the Working Capital.

SECOND MISTAKE FOUND

In Chapter 8, on page 31, we find: "'Cost of revenue' is usually used in place of 'cost of goods sold' if the company is in the business of providing services rather than products."

This affirmation is also incorrect. There is no cost of services, only expenses.

In a commercial company the acquisition of merchandise does not affect the net worth of the company, and for this reason, it is a cost. When this merchandise is resold, their price of acquisition is the cost of merchandise sold.

In an industrial company, the cost of acquisition of raw materials, plus their processing costs, do not affect the net worth of the company, and for this reason, they are considered costs. The revenues from the products sold have, as a cost, the total amount from the processing of raw materials into the products sold.

In a service company, there are no costs but expenses incurred for the obtainment of revenues.
Expenses, unlike Costs, change the net worth of the company.

THIRD MISTAKE FOUND

In Chapter 48, on page 125, “The cash flow statement is broken down into three sections: First, there is cash flow from operating activities: This area starts with net income and then adds back in depreciation and amortization. Though these are real expenses from an accounting point of view, they don’t eat up any cash, because they represent cash that was eaten up years ago. What we end up with is Total Cash from Operating Activities.”

This is an embarrassing mistake because it has no foundation or minimum accounting logic.

Income, thus presented, is the sum that changed the working capital for the period, as we saw in our fiscal period, above. This mistake is related to the erroneous interpretation that profit is cash, and this, as we have seen, is a crass error.

Conclusion

What we can conclude is that even a distinguished analyst, like Warren Buffett, can miss certain aspects of accounting logic, just like an excellent heart surgeon can commit mistakes that do not fundamentally affect his work plan during a surgery, and even so, obtain an excellent final result.