Graham, Benjamin & Meredith, Spencer B. – The Interpretation of Financial Statements

Harper & Brothers Publishers, 1937 (2 ed.) [Equity Investing] Grade ★★★★

A typical way of valuing a business is with the discounted cash flow (DCF) method. Some value investors don't agree with the use of the method due to the need for forecasting uncertain future corporate prospects. Small changes in input values often result in huge swings in the estimated corporate value. Forecasting is deemed futile by investors such as Warren Buffett, Charlie Munger, Bruce Greenwald and James Montier among others. In today's world of competitive disruption there may be alternatives or complements to the DCF method with less dependency on the future that can be used. By studying the current state and the development of the balance sheet and income statement it's possible to understand the health of the business which, in turn, is essential for the firm's future prospects.

Benjamin Graham, the father of value investing, needs no further introduction. His co-author Spencer B. Meredith was an instructor in security analysis at the New York Stock Exchange Institute together with Graham. In this book written before Graham's more influential books, *Security Analysis* and *The Intelligent Investor*, the authors describe how to understand a business and its health by studying the financial statements.

A quote from *The Interpretation of Financial Statements* concludes the authors' view on forecasting: *"Of course, the success of an investment depends ultimately upon future developments, and the future may never be forecast with accuracy. But if you have precise information as to a company's present financial position and its past earnings record, you are better equipped to gauge its future possibilities. And this is the essential function and value of security analysis."*

The Interpretation of Financial Statements is written for those who want to understand the language of business that consists of the financial statements. In the book, the authors describe the most important constituents of balance sheets and income statements one-by-one. The text is structured in three parts. The first part introduces the reader to balance sheets and income statements. Each chapter covers one piece of a financial statement. The authors explain the item and its significance which is essential to know for the security analyst. They also describe different key ratios that are of practical use in order to distinguish if the business is in a favorable condition or in bad shape. In the second part the authors present different financial ratios while the third part is a description of financial terms and phrases.

This is a book for those who would like to understand concepts such as earnings power and book value, which is of essence in the fundamental analysis of a company. By only considering the qualitative aspects of a business the investor is at risk of missing important details that are necessary in order to set a reasonable intrinsic value range. In order to get further guidance on how to use the knowledge in practice, Graham's *Security Analysis* is a great place for further study.

If I were to mention anything negative about the book it would be that the examples drawn are from a different time, meaning that they are typically limited to industrials, railroads and utilities. This is of course no criticism of the authors as the mix of listed companies was truly different in 1937. However, it's important to convert the reasoning and language to a broader set of modern businesses. Even more importantly, the financial statements were arguably more easily structured and read in the first half of the 20th century compared to today's often complex reports. This is also commented upon in the introduction.

I would like to conclude with a timeless statement from the book that summarizes the difficult challenge all investors face: *"Common stock selection is a difficult art - naturally, since it offers large rewards for success. It requires a skillful mental balance between the facts of the past and the possibilities of the future."*

Niklas Sävås, June 07, 2018