



Brian Feroldi 

If you invest, you **MUST** know how to identify a moat.

Here are 9 financial “**rules of thumb**” that **Warren Buffett uses** to tell if a company has one:



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# 1. Gross Margin

Found: **Income Statement**

Formula: **Gross Profit / Revenue**

Moat: Consistently above **40%**

No Moat: Under **40%** & **volatile**

## The 3 Financial Statements

Balance Sheet

Assets		Liabilities	
Current Assets	Cash & Equivalents	Current liabilities	Short-Term Debt
	Marketable Securities		Payables
	Accounts Receivable	Long-term liabilities	Long-Term Debt
	Inventory		Deferred Taxes
Prepaid Expenses		Pension Liabilities	
Long Term Assets	Long Term Investments	Shareholder Equity	Retained Earnings
	Fixed Assets		Treasury Stock
	Intangible Assets		Additional Paid-In capital

Income Statement

Revenue
- Cost of Goods Sold
<b>Gross Profit</b>
- Operating Expenses
Operating Income
- Interest Expense
Pre-Tax Income
- Income Tax
Net Income

Cash Flow Statement

	Net Income
+	Non-cash charges
±	Changes in working capital
	Operating Cash Flow
-	Capital Expenditure for property, plant, equipment
-	Acquisitions
+	Proceeds from sale of investments
	Net cash used in investing activities
±	Borrow / repay debt
±	Issue / repurchase stock
-	Pay dividends
	Net cash used in financing activities



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## **Buffett's logic:**

A **consistently high gross margin** signals that the company isn't competing exclusively on **price**.

A **high gross margin** also **provides** ample gross profit to **pay expenses and leaves money for shareholders**.



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## 2. Sales, General, and Administrative Expenses

Where: **Income Statement**

Formula: **SG&A / Gross Profit**

Moat: Consistently under **30%**

No Moat: Over **80%** & **volatile**

### The 3 Financial Statements

Balance Sheet				Income Statement		Cash Flow Statement	
<b>Assets</b>		<b>Liabilities</b>		Revenue		Net Income	
Current Assets	Cash & Equivalents	Current liabilities	Short-Term Debt	- Cost of Goods Sold		+	Non-cash charges
	Marketable Securities		Payables	<b>Gross Profit</b>		±	Changes in working capital
	Accounts Receivable	Long-term liabilities	Long-Term Debt	- Operating Expenses			Operating Cash Flow
	Inventory		Deferred Taxes	Operating Income		-	Capital Expenditure for property, plant, equipment
	Prepaid Expenses		Pension Liabilities	- Interest Expense		-	Acquisitions
Long Term Assets	Long Term Investments	Shareholder Equity	Retained Earnings	Pre-Tax Income		+	Proceeds from sale of investments
	Fixed Assets		Treasury Stock	- Income Tax		+	Net cash used in investing activities
	Intangible Assets		Additional Paid-In capital	Net Income		-	Borrow / repay debt
						+	Issue / repurchase stock
						-	Pay dividends
							Net cash used in financing activities



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## **Buffett's logic:**

Wide moat companies don't need to spend a lot on overhead to operate. **No moat businesses do.**

Buffett looks for companies that **consistently spend under 30% of their gross profit on SG&A.**





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### 3. Depreciation Expense

Where: **Income Statement & Cash Flow Statement**

Formula: **Interest Expense / Operating Income**

Moat: Consistently under **10%**

No Moat: Volatility & high

## The 3 Financial Statements

Balance Sheet

Assets		Liabilities	
Current Assets	Cash & Equivalents	Current liabilities	Short-Term Debt
	Marketable Securities		Payables
	Accounts Receivable	Long-term liabilities	Long-Term Debt
	Inventory		Deferred Taxes
	Prepaid Expenses		Pension Liabilities
Long Term Assets	Long Term Investments	Shareholder Equity	Retained Earnings
	Fixed Assets		Treasury Stock
	Intangible Assets		Additional Paid-In capital

Income Statement

Revenue	
-	Cost of Goods Sold
Gross Profit	
-	Operating Expenses
Operating Income	
-	Interest Expense
Pre-Tax Income	
-	Income Tax
Net Income	

Cash Flow Statement

Net Income	
+	Non-cash charges
-	Changes in working capital
Operating Cash Flow	
-	Capital Expenditure for property, plant, equipment
-	Acquisitions
+	Proceeds from sale of investments
Net cash used in investing activities	
+	Borrow / repay debt
+	Issue / repurchase stock
-	Pay dividends
Net cash used in financing activities	



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## **Buffett's logic:**

**If depreciation is consistently less than 10% of gross profit**, it's a sign that the company **doesn't need a lot of capital expenditure assets** to maintain its competitive advantage and has a moat.



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## 4. Interest Expense

Where: **Income Statement**

Formula: **Interest Expense / Operating Income**

Moat: Consistently under **15%**

No Moat: Over **50%** & **volatile**

## The 3 Financial Statements

Balance Sheet				Income Statement		Cash Flow Statement	
<b>Assets</b>		<b>Liabilities</b>		Revenue		Net Income	
Current Assets	Cash & Equivalents	Current liabilities	Short-Term Debt	-	Cost of Goods Sold	Operating Activities	Net Income
	Marketable Securities		Payables	Gross Profit			+ Non-cash charges
	Accounts Receivable	Long-term liabilities	Long-Term Debt	-	Operating Expenses		+/- Changes in working capital
	Inventory		Deferred Taxes	Operating Income		Operating Cash Flow	
	Prepaid Expenses		Pension Liabilities	-	Interest Expense	- Capital Expenditure for property, plant, equipment	
Long Term Assets	Long Term Investments	Shareholder Equity	Retained Earnings	Pre-Tax Income		Investing Activities	- Acquisitions
	Fixed Assets		Treasury Stock	-	Income Tax		+ Proceeds from sale of investments
	Intangible Assets		Additional Paid-In capital	Net Income		Net cash used in investing activities	
						Financing Activities	+ Borrow / repay debt
							+ Issue / repurchase stock
							- Pay dividends
						Net cash used in financing activities	





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## **Buffett's logic:**

Great businesses have such wonderful **economics** that they don't need to rely on debt.

While this number varies greatly from industry to industry, **it's a great sign if a company consistently spends less than 15%** of its operating income on interest.



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## 5. Income Tax Expense

Found: **Income Statement**

Formula: **Income Tax Paid / Pre-tax Income (Earnings Before Tax)**

Moat: Consistently pays the full amount (~21% in U.S.)

No Moat: Negative, erratic

### The 3 Financial Statements

Balance Sheet				Income Statement		Cash Flow Statement		
<b>Assets</b>		<b>Liabilities</b>		Revenue		Net Income		
Current Assets	Cash & Equivalents	Current liabilities	Short-Term Debt	-	Cost of Goods Sold	Operating Activities	+	Non-cash charges
	Marketable Securities		Payables	Gross Profit			±	Changes in working capital
	Accounts Receivable	Long-term liabilities	Long-Term Debt	-	Operating Expenses		Operating Cash Flow	
	Inventory		Deferred Taxes	Operating Income		-	Capital Expenditure for property, plant, equipment	
	Prepaid Expenses		Pension Liabilities	-	Interest Expense	-	Acquisitions	
Long Term Assets	Long Term Investments	Shareholder Equity	Retained Earnings	Pre-Tax Income		Investing Activities	+	Proceeds from sale of investments
	Fixed Assets		Treasury Stock	-	Income Tax		Net cash used in investing activities	
	Intangible Assets		Additional Paid-in capital	Net Income		Financing Activities	±	Borrow / repay debt
				+	Issue / repurchase stock			
				-	Pay dividends			
						Net cash used in financing activities		



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## **Buffett's logic:**

Wide moat businesses **make so much money** that they are consistently forced to pay their full share of **taxes**.

Companies that **consistently have negative or an erratic income tax bill** aren't as likely to have a **durable moat**.



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## 6. Profit Margin (Net Margin)

Found: **Income Statement**

Formula: **Net Income / Revenue**

Moat: Consistently above **20%**

No Moat: Below **10%**, negative, and volatile

## The 3 Financial Statements

Balance Sheet

Assets		Liabilities	
Current Assets	Cash & Equivalents	Current liabilities	Short-Term Debt
	Marketable Securities		Payables
	Accounts Receivable	Long-term liabilities	Long-Term Debt
	Inventory		Deferred Taxes
Prepaid Expenses		Pension Liabilities	
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Income Statement

Revenue	
-	Cost of Goods Sold
Gross Profit	
-	Operating Expenses
Operating Income	
-	Interest Expense
Pre-Tax Income	
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Net Income	

Cash Flow Statement

Net Income	
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Operating Cash Flow	
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## Buffett's logic:

Companies that consistently **convert 20%** of their **revenue** into net income likely have a moat.

If this number is **under 10%, negative, or volatile**, it's an **indication that competition is fierce**.

**(There's plenty of nuance between 10% and 20%).**





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## 7. Capital Expenditures

Found: **Income Statement & Cash Flow Statement**

Formula: **Capital Expenditures / Net Income**

Moat: Consistently under **25%**

No Moat: Consistently above **75%**

### The 3 Financial Statements

Balance Sheet				Income Statement		Cash Flow Statement	
<b>Assets</b>		<b>Liabilities</b>		Revenue		Net Income	
Current Assets	Cash & Equivalents	Current liabilities	Short-Term Debt	-	Cost of Goods Sold	Operating Activities	Net Income
	Marketable Securities		Payables	Gross Profit			+ Non-cash charges
	Accounts Receivable	Long-term liabilities	Long-Term Debt	-	Operating Expenses		+/- Changes in working capital
	Inventory		Deferred Taxes	Operating Income		Operating Cash Flow	
	Prepaid Expenses		Pension Liabilities	-	Interest Expense	- Capital Expenditure for property, plant, equipment	
Long Term Assets	Long Term Investments	Shareholder Equity	Retained Earnings	Pre-Tax Income		Investing Activities	- Acquisitions
	Fixed Assets		Treasury Stock	-	Income Tax		+ Proceeds from sale of investments
	Intangible Assets		Additional Paid-In capital	Net Income		Net cash used in investing activities	
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## Buffett's logic:

Capital expenditures eat into **profits**.  
Companies that **don't** have to spend big on capex have more money to **reward shareholders**.

**Important:** Capital **Expenditures** can vary greatly from year to year. Averaging the result over **10+ years** is best.



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## 8. Total Liabilities to Adjusted Shareholder Equity

Found: **Balance Sheet**

Formula: **Total Liabilities / Shareholder Equity**

Moat: Below **0.80**

No Moat: Over **2.00**

### The 3 Financial Statements

Balance Sheet		Income Statement		Cash Flow Statement		
<b>Assets</b>		<b>Revenue</b>		<b>Net Income</b>		
Current Assets	Cash & Equivalents	-	Cost of Goods Sold	+	Non-cash charges	
	Marketable Securities		<b>Gross Profit</b>	±	Changes in working capital	
	Accounts Receivable		-	Operating Expenses		
	Inventory		<b>Operating Income</b>		<b>Operating Cash Flow</b>	
	Prepaid Expenses		-	Interest Expense	-	Capital Expenditure for property, plant, equipment
Long Term Assets	Long Term Investments		<b>Pre-Tax Income</b>		<b>Acquisitions</b>	
	Fixed Assets		-	Income Tax	+	Proceeds from sale of investments
	Intangible Assets		<b>Net Income</b>		<b>Net cash used in investing activities</b>	
				+	Borrow / repay debt	
				+	Issue / repurchase stock	
				-	Pay dividends	
					<b>Net cash used in financing activities</b>	



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**Buffett's logic:**

Wide **moat businesses finance themselves with profits**, not debt.

However, **stock buybacks can throw off this equation.**

Adjust for this by **adding back any treasury stock** to the shareholder equity number.



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## 9. Return on Shareholders' Equity

Found: **Balance Sheet & Income Statement**

Formula: **Net Income / Shareholder Equity**

Moat: Consistently above **15%**

No Moat: Below **10%**, negative, or volatile

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## Buffett's logic:

Return on equity shows **how effectively management is reinvesting its profits**. A number consistently over 15% **indicates that the business has a moat**.

**Under 10%, negative, or volatile** indicates that the business is **struggling with competition**.





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## **CONSISTENCY is also key**

The real test is if a **company generates good numbers** over multiple years & various economic cycles.

**There are PLENTY of exceptions & nuances to these rules, too!**

Many of **Buffett's** largest holdings do not pass every rule of thumb.

That's because **investing & accounting** have **TONS** of nuances.

**Still, rules of thumb are very helpful.**



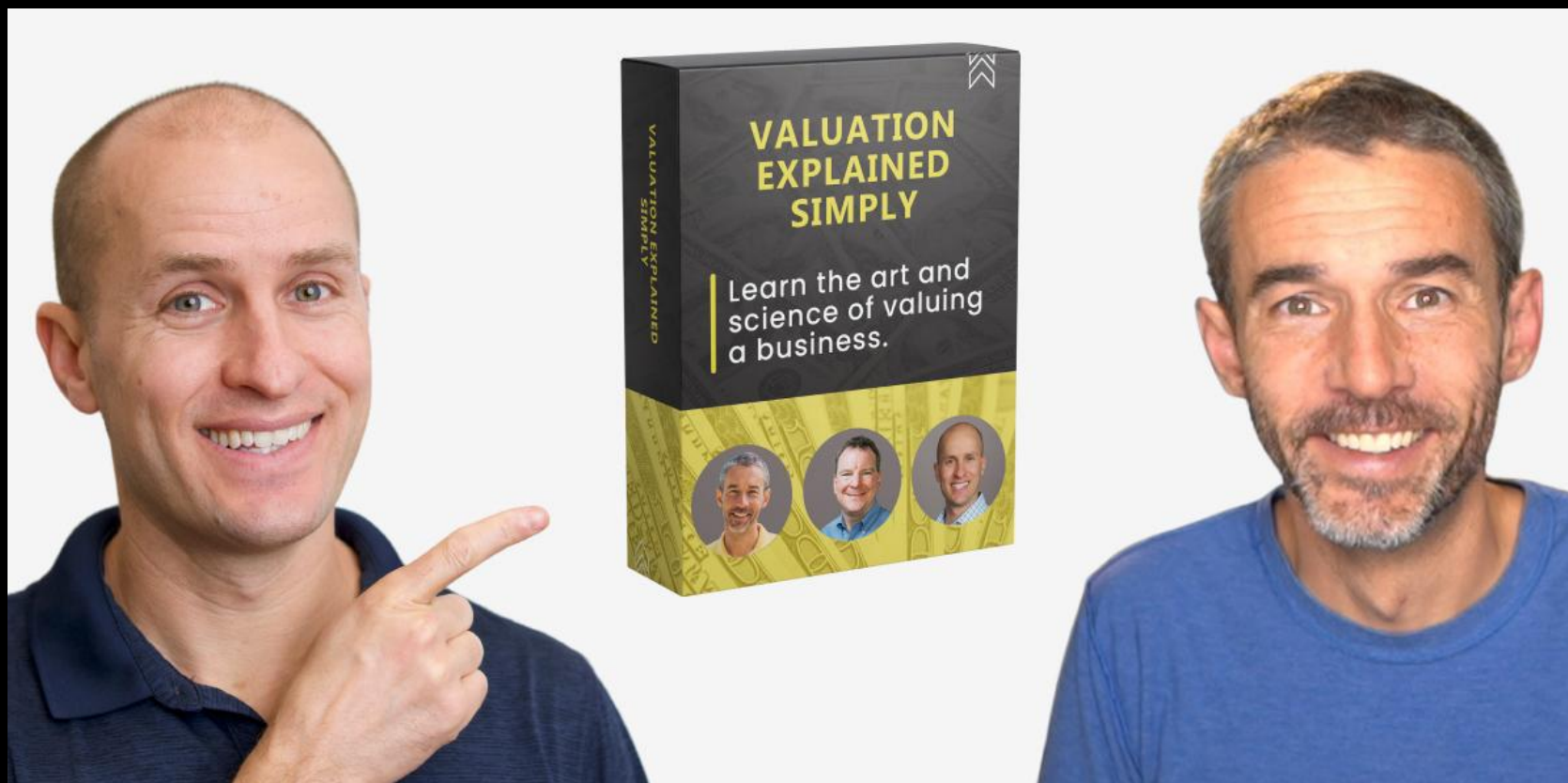
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