BERKSHIRE HATHAWAY'S UNCOMMON ACCOUNTING

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Berkshire Hathaway Inc. ("Berkshire" or "Berkshire Hathaway") is a work of art assembled not from the usual materials of artists, but from the materials of corporate law, financial theory, and common sense mixed with humor. Like many good works of art, Berkshire Hathaway is presented in a natural and unassuming manner, as if it was nothing more than the inevitable consequence of the materials themselves. It is different in many respects from other American corporations, and its unique features, such as its share price (more than 300 times the price of a typical NYSE stock), its stable shareholder body, and its chairman's frequent admissions of error, are worth examining.

I focus in this Article on Berkshire Hathaway's presentation of summary financial statements, its presentation of "look-through" earnings, and its explicit discussion of accounting issues in the chairman's letters.

American corporations with public shareholders, such as Berkshire Hathaway, are required to present financial statements in accordance with Generally Accepted Accounting Principles ("GAAP").1 GAAP is an amalgam of traditional accounting principles, which are increasingly supplemented by detailed pronouncements of the Financial Accounting Standards Board on issues relating to the acceptable presentation of financial statements.

Although it is not a legal requirement that a company present only GAAP summary statements, it is the practice to do so. The GAAP financial statements produce one number which has been a central focus of securities analysts—earnings per share. The earnings per share is used along with the price-earnings ratio to estimate the value of the issuer's securities. Although earnings per share is presented as a single number, it necessarily reflects many

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1 These requirements arise under the Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a-78ff (1994), and apply to any company listed on an exchange (as Berkshire Hathaway is), or to companies with assets in excess of $5,000,000 and more than 300 U.S. shareholders. See 15 U.S.C.A. § 78l(a), (g) (West 1981 & Supp. 1997), and implementing regulations.
intermediate estimates and conventions such as those relating to revenue recognition, depreciation, deferred tax liabilities, and unfunded pension costs. As a result, the earnings per share is more correctly thought of as an estimate than as a precise figure. The amount of uncertainty implicit in the estimate, however, is never discussed in corporate reports.

Unlike perhaps any of its peers, Berkshire Hathaway reports its financial results in a way that emphasizes the judgment and uncertainty necessarily embodied in the financial accounting statements. It does this in three ways. First, it goes beyond the presentation of the required statements, and presents an additional set of financial statements not computed in accordance with GAAP. Second, the reports emphasize a second earnings figure in what the letters call look-through earnings. And third, the letter to shareholders does not treat accounting as an objective given, but discusses at considerable length the differences between Berkshire's accounting results and the economic and business realities.

I. THE SEPARATE FINANCIAL STATEMENTS

Berkshire’s separate financial statements are appended to its annual reports, printed on a different color paper, and carry the legends: “These statements do not conform to GAAP in all respects. These statements are unaudited.” An introductory page explains:

The presentations in this section do not conform in all respects to generally accepted accounting principles. Principal departures from GAAP relate to accounting treatment for assets acquired in business acquisitions, although students and practitioners of accounting will recognize others.

Opinions of Berkshire's independent auditors were not solicited for this data. The four-category presentations in no way fell within their purview.

The introduction to these statements further explains that in the separate statements, “Berkshire’s consolidated data is rearranged in the presentations on the following six pages into four categories, corresponding to the way Mr. Buffett and Mr. Munger think about

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2 I say perhaps because it seems likely that there are other examples. I, however, am not aware of any as a result of a random and very partial search.


4 Id. at 51.
Berkshire’s businesses. The presentations may be helpful to readers in making estimates of Berkshire’s intrinsic value.\(^5\)

The four categories are: (1) insurance group; (2) manufacturing, publishing, and retailing businesses; (3) finance businesses; and (4) non-operating activities. In contrast, the segmentation in the GAAP statements is based on eight lines of business: insurance, candy, encyclopedias, home cleaning systems, home furnishings, newspaper, shoes, and uniforms.

In the GAAP presentation, each of the eight lines of business is charged with acquisition costs, which then affect their reported profitability. The four-part presentation in the separate financial statements, however, charges the acquisition premiums (amounts paid for businesses in excess of their then book values) not to the operating businesses which were acquired, but to “non-operating activities,” which are the headquarters activities, i.e., the activities of Buffett and Munger. As a result, Buffett and Munger’s “non-operating activities” lose significant amounts of money.\(^6\) The basic rationale for handling acquisition charges this way is that Buffett and Munger, who make the decision to pay premium amounts, are responsible for the acquisition premiums, not the acquired businesses or their managers.

The supplemental, non-GAAP financial statements are not simple transpositions of the GAAP numbers that any sophisticated user of the GAAP statements could produce. They segment the reporting in a different way and they involve adjustments for different subsidiaries originating in different years. As a result, they contain unique information, not otherwise available, on questions such as the impact of purchase price adjustments on Berkshire’s current earnings, and they can only be produced by someone with access to the corporate accounting records.

II. LOOK-THROUGH EARNINGS

Look-through earnings are the earnings of companies in which Berkshire holds a major portfolio position divided by Berkshire’s proportional interest. Since Berkshire holds a non-controlling interest in these companies, their earnings are not consolidated in Berkshire’s accounting statements. Instead, Berkshire reports as income only dividends received. However, if the investees hold the

\(^5\) Id.

earnings in excess of dividends, an amount that is quite large in the case of many of the investees, and invest them in a way that earns above-market rates of return, then the reinvestment benefits Berkshire. The size of the benefit to Berkshire is suggested by the look-through earnings, which are significantly higher than the GAAP earnings.

III. THE ACCOUNTING LESSONS IN THE CHAIRMAN'S LETTERS

Most corporate reports treat accounting statements as if they are produced by an external mechanism, which leads automatically, or at least inexplicably, to the production of the accounting numbers. It is as if managements are afraid that if they mention the estimates, the uncertainties, and the choices involved in accounting numbers, investors might lose faith in them. Berkshire chairman's letters have a different attitude. These letters openly discuss possible perspectives on and estimates inherent in the summary statements. They offer instructions on a number of important and basic points. The reader can distill from them the following lessons about accounting.

A. Accounting Rules—Compromising and Arbitrary

The letters stress over and over again that accounting rules, no matter how carefully constructed, are necessarily arbitrary rules and cannot be expected to produce one "right" answer. At several points Buffett observes: "I would hate to have the job of devising a better set of rules." The letters also stress over and over again that the job of the accountant is to record, not evaluate. Valuation is the job of managers and investors.

B. Intrinsic Worth

For purposes of valuation, the letters stress intrinsic value, defined as "the discounted value of the cash that can be taken out of a business during its remaining life." While the definition is easy, the calculation is hard.

The calculation of intrinsic value . . . is not so simple. As our definition suggests, intrinsic value is an estimate rather than a precise figure. . . . Two people looking at the same set of facts, moreover . . . will almost inevitably come up with at least slightly

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8 See, e.g., id. at 187.
9 Id.
different intrinsic value figures. That is one reason we never give you our estimates of intrinsic value. What our annual reports do supply, though, are the facts that we ourselves use to calculate this value.\textsuperscript{10}

C. Economic Goodwill, Accounting Goodwill, and Purchase Accounting

Because Berkshire has purchased a significant number of businesses at prices over book value, the accounting rules require Berkshire to write up the values of the acquired assets to their current values and to recognize any amount paid in excess of the asset values as an asset item called "goodwill." The goodwill then must be amortized over forty years, and the other assets depreciated as appropriate to their asset classes. As a result, a business purchased at a premium over book value will have lower accounting earnings after the purchase than before, even though there has been no change in the business.

The letters go to considerable lengths to explain that these accounting adjustments do not mean that the purchased business is a less successful economic entity after it was purchased than before. Buffett explains that there is substantial difference between goodwill as the accounting asset and goodwill as the value that inheres in a business because of its success. The second kind of goodwill, the kind that justifies paying a premium price for a business, does not necessarily depreciate. Indeed, if the business purchased was wisely chosen and subsequently well managed, its economic or true goodwill should continue to appreciate as the business becomes more valuable. Accounting goodwill is simply an adjustment figure to bring the book value figures in line with the purchase price.

Some readers might take Buffett's comments in these letters as a criticism of purchase accounting and as advocacy of pool accounting. That, however, is a misinterpretation. Purchase accounting adjustments are perfectly appropriate for accounting, where the purpose is to account for funds. For purposes of valuation, however, the resulting accounting numbers can be misleading if the business in fact has economic goodwill, and that goodwill is increasing in value over time.

\textsuperscript{10} Id.
D. Consolidation and Segmentation

The letters emphasize that Berkshire's consolidated results are of almost no use in determining intrinsic value. The principal reason for this in Berkshire's case is that the consolidation rules do not permit Berkshire to include in its consolidated earnings its share of the earnings of its major investees. The consolidation rules require Berkshire to have control over the firms whose results are consolidated, and Berkshire does not control its major investees. As a result, all that is included in Berkshire's income is the dividends it received. To compensate for this problem with the consolidated results, Berkshire separately summarizes its look-through earnings.

E. Insurance Results, Super-Catastrophe Risk, and Periodic Accounting

A large part of the accounting rules concern the assumptions used to generate results of a single period, be it a quarter or a year. For instance, the concept of depreciation is used to allocate the cost of an asset with a life greater than a single period over its entire life. How much cost is allocated to a single period, however, is necessarily arbitrary.

In Berkshire's case, it has a very large insurance business, which is particularly susceptible to these problems. Policies are written and premium income is received in one period, claims for losses are received and paid in another. Loss reserves are used in anticipation of future claims and charged to the period when the premium income is received. But this process can only be a rough estimate at best, and can result in unrealistically high profitability for a substantial period of time.

One area where this problem of period allocation severely affects the realism of Berkshire's results is its business of writing reinsurance contracts to cover super-catastrophe risk. In recent years, Berkshire has had the good fortune of writing a number of such contracts for risks that did not materialize. Needless to say, that leads to positive economic results. But since Berkshire plans to stay in the business, it seems unlikely that the good fortune will continue forever. Thus, the current positive economic results are unrealistically high.

The letters emphasize over and over again that Berkshire makes its decision based on the economic profitability of a project without concern about the smoothness of its quarter-to-quarter numbers.
Why are the reporting practices of Berkshire Hathaway so different from those of other American issuers? One reason is that Buffett owns a controlling block of Berkshire Hathaway; he can be as idiosyncratic as he wants without threatening his job security. For an executive without this kind of job protection, it is always tempting to follow the herd and conform to the practices of everyone else.

This usual conformity of corporate reporting practices can be explained for the safety of numbers. No corporation can be criticized for reporting in ways that are identical to those of everyone else. The legal system plays a role in generating this behavior as well. Faced with a lawsuit claiming that GAAP numbers are misleading, an issuer can defend on the ground that GAAP is required by the Securities and Exchange Commission. Faced with a lawsuit claiming that numbers presented in its own format are misleading, the issuer has to defend the numbers on their own merits. It is easy to imagine the worried countenances of securities lawyers who were asked to advise on the risks of this practice, and it is not surprising that Berkshire’s separate financial statements carry the legend: “These statements do not conform to GAAP in all respects[.] These statements are unaudited.”

Aside from the legends, the hand of the lawyer is evident in one other thing. Berkshire Hathaway did not report look-through earnings in 1995 “for special and nonrecurring reasons.” The most obvious reason is that the 1995 Annual Report was issued shortly before the public offering of the “Baby Berkshire” or Class B stock, and lawyers may have been concerned that brokers would use the look-through earnings number to promote its sale.

Berkshire Hathaway’s distinctive reporting practices, however, are much more than an expression of the idiosyncratic style of a particular individual. They reflect a calculated effort to attract to Berkshire Hathaway a shareholder group with particular character-

13 These shares, representing 1/30th of the regular common shares, were sold in a public offering on May 8, 1996 at $1,118.00 a share. The 1995 chairman’s letter is dated March 1, 1996. See 1995 Annual Report, supra note 6, at 22.
14 In 1994, Berkshire Hathaway reported GAAP earnings of $494,798,000 or $420 a share. At the end of the year the stock sold for about $20,000 a share, for a price-earnings ratio of about 47. The calculation of look-through earnings showed that it increased earnings by about seventy percent. An unscrupulous stock salesman could argue that since Berkshire’s earnings were “really” 70% higher, a share “really” should sell for $34,000. The fallacy in this argument is that the market has already taken Berkshire’s look-through earnings, and other factors, into account in its valuation of the stock.
istics, i.e., shareholders who will think of themselves as partners with long-term interests in the business and thus behave like partners. Berkshire’s reporting style is not the only feature Berkshire uses to accomplish this objective, but it is an important part of the strategy.

A second reason why Berkshire Hathaway’s reporting practice is different from those of other American issuers is that Berkshire Hathaway is a holding company with an unusual structure. The holding company is not involved in the management of its subsidiaries, except in two respects. First, the holding company selects the top management of the subsidiaries—in many cases the same people who were running the business when Berkshire Hathaway acquired it. Second, the holding company allocates capital to the subsidiaries. Other than these aspects, it is for the managements of the subsidiaries to manage “their” businesses. Buffett thereby has almost the same relationship with the wholly-owned subsidiaries as he has with portfolio companies.

Because Buffett is not involved in front-line management, he can discuss his activities in great detail without disclosing anything about the business strategies or market challenges faced by either the operating or portfolio companies. The letters constantly reassure shareholders that Berkshire’s companies are in excellent businesses with world-class managers, but never quite explain how one can tell which of the many businesses is excellent, and how one can identify the traits of a world-class manager. Of course, once the business has, over a period of ten years or more, achieved a record that is consistently better than that of its competitors and most other companies, it is hard to argue that the description is not correct. But Buffett does not explain how one would know in advance that television stations would continually appreciate in value.

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15 Examples of other features of Berkshire Hathaway that have the same goal are the corporate contribution program, which enables owners of registered shares to designate recipients (thus creating an incentive for owners to take the shares out of street name and register them directly with the company), and the no-split policy, which makes it difficult for smaller shareholders to sell a small part of their holdings.

16 The inability of managements to report to shareholders of a public company in a way that will not make the information accessible to competitors and other third parties with interests adverse to the issuer is a central disclosure problem. I discuss its impact on the compulsory U.S. disclosure system in Edmund W. Kitch, The Theory and Practice of Securities Disclosure, 61 BROOK. L. REV. 763 (1995).

17 And, not surprisingly, Berkshire has some businesses that are not world-class, or at least are troubled: for example, World Book, which was hard hit by the advent of inexpensive CD-ROM products, see 1995 ANNUAL REPORT, supra note 6, at 48 (1996), or shoes group—H.H. Brown Shoe Company, Inc., Lowell Shoe, Inc., and Dexter Shoe Companies. See id. at 50.
Did he use statistical data to predict that viewers would be willing to spend more and more time watching television? Did he understand why cable distribution would never become a full substitute for broadcast distribution? Or did he perceive that the management of Cap Cities had a uniquely effective management strategy? Berkshire Hathaway can be very candid about what its holding company management is doing without revealing what the operating and portfolio companies are doing.

When confidentiality about the actions of the holding company is important—such as in plans to either buy or sell stock in portfolio companies—Buffett makes it clear that this is an area that will not be discussed.¹⁸

One basic theme of the discussions on accounting is that the results for any one period are dictated by accounting conventions. Owners therefore need to look behind the accounting numbers to evaluate the intrinsic worth of the businesses themselves. Because the accounting numbers for any one period may reflect accounting conventions or even just plain luck, and because the intrinsic value is certain to grow in the long term while nothing is certain in the short-term, holders of the stock need to think long-term, not short-term.

Even though Berkshire’s style of penetrating the seeming mystery of accounting numbers by providing alternatives and by explicitly discussing the impact of accounting on the reported GAAP results is unusual, it appears to have been highly successful in achieving its objectives. Given that Berkshire Hathaway can easily be viewed as a closed-end investment company, and that closed-end investment companies usually sell at a discount to their net asset values, it is notable that Berkshire Hathaway appears to sell above its net asset value. This suggests that shareholders like to be treated like grown-up partners. It is a style of reporting that would probably work for other American issuers as well, if they were brave enough to try it.

¹⁸ See Buffett Essays, supra note 7, at 37. Buffett’s Principle 13 states: Despite our policy of candor, we will discuss our activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore we normally will not talk about our investment ideas. This ban extends even to securities we have sold (because we may purchase them again) and to stocks we are incorrectly rumored to be buying. If we deny those reports but say “no comment” on other occasions, the no-comments become confirmation.

Id. (emphasis omitted).