

See's Candies Case Study September 2012

Excerpts from *Teaching Accounting and Valuation in the Basic Corporation Law Course* by Elliott J. Weiss

Buffett on accounting: (Buffett quotes highlighted)

Accounting numbers, of course, are the language of business and as such are of enormous help to anyone evaluating a business and tracking its progress....They invariably are the starting point...in evaluating our own businesses and those of others. Managers and owner need to remember, however, accounting is but an aid to business thinking, not a substitute for it.

However, Mr. Buffett's observation in large part reflects the view of the owner/manager of a business—the person who uses accounting primarily to keep track of, and exercise control over, a firm that she owns or operates. From the perspective of this owner/manager, the more accurately financial statements reflect the business financial status and progress, the better.

Beware of those who represent accounting as a search for some sort of objective truth—or at least a reasonable approximation of that objective truth.

There are **three fundamental truths** about accounting that every investor should understand.

First, when dealing with financial statement prepared on an **accrual** basis, as almost all financial statements are, there is **no such thing as objective truth**. Many judgments are required.¹ Many estimates must be made.² Many accounts can be conceptualized in different ways, all of which are consistent with GAAP, and then assigned the value most consistent with that conceptualization.³

Warren Buffet acknowledges this reality. He has noted that “earnings can be as pliable as putty when a charlatan heads the company reporting them. Eventually truth will surface, but in the meantime a lot of money can change hands.” He has observed: “Many managements view GAAP not as a standard to be met, but as an obstacle to be overcome. Too often their accountants ...assist them....Even honest and well-intentioned managements sometimes stretch GAAP a bit....”

Then there are managers who actively use GAAP to deceive and defraud.

The **Appendix to the 1983 Berkshire Hathaway Letter to Shareholders** both clarifies the concept of accounting Goodwill and illustrates that factors not reflected on the balance sheet often are most important in determining the value of a business. Accounting Goodwill, as Buffett points out, is a product of accounting convention. If someone pays more to purchase a firm than the fair market value of the firm's identifiable assets, GAAP requires the purchaser to assign the difference to an account called “Goodwill” and then to write off the value of that purchased Goodwill, as a charge against earnings, over a period of not more than forty years.

¹ For example, should payment for advertising services be accounted for as an expense or a deferred charge?

² For example, what portion of a bank's outstanding loans will not be repaid and thus should be reflected in additions to its allowance for bad debts?

³ For example, inventory can be visualized as being sold at random from a bin and valued on the basis of its average cost. It can be visualized as flowing through a pipeline and valued on a first-in, first-out (**FIFO**) basis. Or it can be visualized as being added to and sold from the top of a stack and valued on a last-in, first-out (**LIFO**) basis.

Mr. Buffett uses a discussion of Berkshire Hathaway's purchase of See's Candy Shops to illustrate the difference between accounting Goodwill and economic Goodwill. He begins by noting that "businesses logically are worth far more than net tangible assets when they can be expected to produce earnings on such assets considerably *in excess* of market rates of return." This was true of See's, which had net tangible assets of about \$8 million and after-tax earnings of about \$2 million when *Blue Chip Stamps*, a Berkshire Hathaway subsidiary, purchased it in 1972. Buffett points out that it was See's "**pervasive favorable reputation with consumers based upon countless pleasant experiences they have had with both product and personnel,**" that allowed it to generate annual after-tax earnings equal to more than 25% of the value of its tangible assets—a performance that few businesses can match, and one that seemed to him to justify paying \$25 million, or \$17 million in excess of the value of See's tangible assets, to purchase that company.

Berkshire, in accord with GAAP, recorded the \$17 million as Goodwill on its books. Over the next eleven years, also in accord with GAAP, Berkshire reduced See's reported earnings by \$425,000 per year in order to amortize the cost of the acquired Goodwill. Thus, after eleven years, the book value of See's Goodwill account was about \$12.5 million.

However, as Mr. Buffett points out, these amortization charges reflect only the requirements of GAAP, not economic reality. In 1982, See's earned \$13 million after taxes with net tangible assets of about \$20 million—a return of 65% on the value of See's tangible assets and of about 37% on the value of those assets plus the \$17 million Berkshire Hathaway paid for See's Goodwill in 1972. This performance suggests both that See's economic Goodwill increased substantially in the years after it was acquired by Berkshire and that Berkshire did not overpay when it bought See's.

Buffett's extensive 20 years of experience analyzing businesses helped him recognize both the franchise power and latent (untapped) pricing power of See's Candies.

Franchise vs. Commodity Business

We *contrast* Mr. Buffett's discussion of Berkshire Hathaway's experience with See's with his description of Berkshire's experience in the textile business, which Mr. Buffett describes as a business that logically was worth **far less than net tangible assets because it was incapable of producing earnings on such assets equal to market rates of return.** Thus, he states in his **1978 letter** shareholders:

Textiles

Earnings of \$1.3 million in 1978, while much improved from 1977, still represent a low return on the \$17 million of capital employed in this business. Textile plant and equipment are on the books for a very small fraction of what it would cost to replace such equipment today. And, despite the age of the equipment, much of it is functionally similar to new equipment being installed by the industry. But despite this "bargain cost" of fixed assets, capital turnover is relatively low reflecting required high investment levels in receivables and inventory compared to sales. Slow capital turnover, coupled with low profit margins on sales, inevitably produces inadequate returns on capital. Obvious approaches to improved profit margins involve differentiation of product, lowered manufacturing costs through more efficient equipment or better utilization of people, redirection toward fabrics enjoying stronger market trends, etc.

Our management is diligent in pursuing such objectives. The problem, of course, is that our competitors are just as diligently doing the **same** thing. (*No barriers to entry*)

The textile industry illustrates in textbook style how **producers of relatively undifferentiated goods in capital intensive businesses must earn inadequate returns except under conditions of tight supply or real shortage.**** As long as excess productive capacity exists, prices tend to reflect direct operating costs rather than capital employed. Such a supply-excess condition appears likely to prevail most of the time in the textile industry, and our expectations are for profits of relatively modest amounts in relation to capital.

We hope we don't get into too many more businesses with such tough economic characteristics. But, as we have stated before:

- (1) Our textile businesses are very important employers in their communities,
- (2) Management has been straightforward in reporting on problems and energetic in attacking them,
- (3) Labor has been cooperative and understanding in facing our common problems, and
- (4) The business should average modest cash returns relative to investment. As long as these conditions prevail - and we expect that they will - we intend to continue to support our textile business despite more attractive alternative uses for capital.

**

Analyzing commodity businesses

To understand the change, we need to look at some major factors that affect levels of corporate profitability generally. Businesses in industries with both substantial over-capacity and a "commodity" product (undifferentiated in any customer-important way by factors such as performance, appearance, service support, etc.) are prime candidates for profit troubles. These may be escaped, true, if prices or costs are administered in some manner and thereby insulated at least partially from normal market forces. This administration can be carried out (a) legally through government intervention (until recently, this category included pricing for truckers and deposit costs for financial institutions), (b) illegally through collusion, or (c) "extra-legally" through OPEC-style foreign cartelization (with tag-along benefits for domestic non-cartel operators).

If, however, costs and prices are determined by full-bore competition, there is more than ample capacity, and the buyer cares little about whose product or distribution services he uses, industry economics are almost certain to be unexciting. They may well be disastrous.

Hence the constant struggle of every vendor to establish and emphasize special qualities of product or service. This works with candy bars (customers buy by brand name, not by asking for a "two-ounce candy bar") but doesn't work with sugar (how often do you hear, "I'll have a cup of coffee with cream and C & H sugar, please"). *Differentiation without customer captivity is meaningless.*

In many industries, differentiation simply can't be made meaningful. A few producers in such industries may consistently do well if they have a cost advantage that is both wide and sustainable. By definition such exceptions are few, and, in many industries, are non-existent. For the great majority of companies selling "commodity" products, a depressing equation of business economics prevails: **persistent over-capacity without administered prices (or costs) equals poor profitability.**

Of course, over-capacity may eventually self-correct, either as capacity shrinks or demand expands. Unfortunately for the participants, such corrections often are long delayed. When they finally occur, the **rebound to prosperity frequently produces a pervasive enthusiasm for expansion** that, within a few years, again creates over-capacity and a new profitless environment. **In other words, nothing fails like success.**

What finally determines levels of long-term profitability in such industries is the ratio of supply-tight to supply-ample years. Frequently that ratio is dismal. (It seems as if the most recent supply-tight period in our textile business - it occurred some years back - lasted the better part of a morning.)

In some industries, however, capacity-tight conditions can last a long time. Sometimes actual growth in demand will outrun forecasted growth for an extended period. In other cases, adding capacity requires very long lead times because complicated manufacturing facilities must be planned and built.

--

One can develop potentially valuable insights into the dynamics of a company's business. A business such as See's is valuable in large part because it possesses considerable economic Goodwill-intangibles that allow it to earn extraordinary returns on its net tangible assets. Other businesses have different dynamics, and may not even be worth as much as it would cost to replace their tangible assets. **Understanding these differences** not only can help students to evaluate businesses, but also can assist them in understanding what really is at stake in many of the corporate law cases they study.

A second critical factor in evaluating what a business is worth to its owners is what Mr. Buffett calls "owner earnings." In our casebook, we introduce concepts of valuation with a wonderful parable, written primarily by the late Professor Donald Schwartz, called "The Old Man and the Tree." It concludes with a discussion between the Old Man and a young business school graduate about whether it makes more sense to use capitalized earnings or discounted cash flow to value the apple tree the Old Man is selling. We use Mr. Buffett's discussion of owner earnings to reinforce the lessons of the parable and to suggest a somewhat more refined—and considerably more pragmatic—way in which students can think about how much a business is worth.

Owner earnings, as Mr. Buffett defines them, "represent

- (a) Reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges...less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. (plus any additions to working capital) that the business requires to fully *maintain its long-term competitive position and its unit volume.*"

Mr. Buffett notes that his "owner-earnings equation does not yield the deceptively precise figures provided by GAAP, since **(c or Maintenance Capex) must be a guess—and one sometimes very difficult to make.**" He continues: **"Despite this problem, we consider the owner earnings figure, not the GAAP figure, to be the relevant item for valuation purposes—both for investors in buying stocks and for managers in buying entire businesses."** This is so because **managers must commit new funds to almost every business, almost every year, in order to maintain its competitive position.**

We find it useful to teach Mr. Buffett's concept of owner earnings for at least two reasons:

- First, the concept highlights the *limitations* of relying exclusively on either GAAP earnings or “cash flow” to value a business. This drives home the lesson that “accounting is but an aid to business thinking, never a substitute for it.”
- Second, Mr. Buffett’s formula for calculating owner earnings implicitly builds on his earlier discussion of **economic Goodwill**. In a firm with substantial economic Goodwill, **c** will tend to be modest in relation to the sum of (a) and (b). A firm like Berkshire’s textile business, on the other hand, is likely to find that (c) often will be as large as, or even larger than, the sum of (a) and (b). Its owner earnings, and thus its value to its owners, will be small indeed. In other words, the business is a money pit—you put in more investment than the business ever returns.

1983 Appendix

BERKSHIRE HATHAWAY INC.

Goodwill and its Amortization: The Rules and the Realities

This appendix deals only with economic and accounting Goodwill – not the goodwill of everyday usage. For example, a business may be well liked, even loved, by most of its customers but possess no economic goodwill. (AT&T, before the breakup, was generally well thought of, but possessed not a dime of economic Goodwill.) And, regrettably, a business may be disliked by its customers but possess substantial, and growing, economic Goodwill. So, just for the moment, forget emotions and focus only on economics and accounting.

When a business is purchased, accounting principles require that the purchase price first be assigned to the fair value of the identifiable assets that are acquired. Frequently the sum of the fair values put on the assets (after the deduction of liabilities) is less than the total purchase price of the business. In that case, the difference is assigned to an asset account entitled “excess of cost over equity in net assets acquired”. To avoid constant repetition of this mouthful, we will substitute “Goodwill”.

Accounting Goodwill arising from businesses purchased before November 1970 has a special standing. Except under rare circumstances, it can remain an asset on the balance sheet as long as the business bought is retained. That means no amortization charges to gradually extinguish that asset need be made against earnings.

The case is different, however, with purchases made from November 1970 on. When these create Goodwill, it must be amortized over not more than 40 years through charges – of equal amount in every year – to the earnings account. Since 40 years is the maximum period allowed, 40 years is what managements (including us) usually elect. This annual charge to earnings is not allowed as a tax deduction and, thus, has an effect on after-tax income that is roughly double that of most other expenses.

That’s how accounting Goodwill works. To see how it differs from economic reality, let’s look at an example close at hand. We’ll round some figures, and greatly oversimplify, to make the example easier to follow. We’ll also mention some implications for investors and managers.

Blue Chip Stamps bought See’s early in 1972 for \$25 million, at which time See’s had about \$8 million of net tangible assets. (Throughout this discussion, accounts receivable will be classified as tangible assets, a definition proper for business analysis.) This level of tangible assets was adequate to conduct the business without use of debt, except for short periods seasonally. See’s was earning about \$2 million after tax at the time, and such earnings seemed conservatively representative of future earning power in constant 1972 dollars.

Thus our first lesson: businesses logically are worth far more than net tangible assets when they can be expected to produce earnings on such assets considerably in excess of market rates of return. The capitalized value of this excess return is economic Goodwill.

In 1972 (and now) relatively few businesses could be expected to consistently earn the 25% after tax on net tangible assets that was earned by See's – doing it, furthermore, with conservative accounting and no financial leverage. It was not the fair market value of the inventories, receivables or fixed assets that produced the premium rates of return. Rather it was a combination of **intangible assets, particularly a pervasive favorable reputation with consumers based upon countless pleasant experiences they have had with both product and personnel.**

Such a reputation creates a **consumer franchise** that allows the value of the product to the purchaser, rather than its production cost, to be the major determinant of selling price. Consumer franchises are a prime source of economic Goodwill. Other sources include governmental franchises not subject to profit regulation, such as television stations, and an enduring position as the low cost producer in an industry.

Let's return to the accounting in the See's example. **Blue Chip's purchase of See's at \$17 million over net tangible assets required that a Goodwill account of this amount be established as an asset on Blue Chip's books and that \$425,000 be charged to income annually for 40 years to amortize that asset. By 1983, after 11 years of such charges, the \$17 million had been reduced to about \$12.5 million. Berkshire, meanwhile, owned 60% of Blue Chip and, therefore, also 60% of See's. This ownership meant that Berkshire's balance sheet reflected 60% of See's Goodwill, or about \$7.5 million.**

In 1983 Berkshire acquired the rest of Blue Chip in a merger that required purchase accounting as contrasted to the "pooling" treatment allowed for some mergers. Under purchase accounting, the "fair value" of the shares we gave to (or "paid") Blue Chip holders had to be spread over the net assets acquired from Blue Chip. This "fair value" was measured, as it almost always is when public companies use their shares to make acquisitions, by the market value of the shares given up.

The assets "purchased" consisted of 40% of everything owned by Blue Chip (as noted, Berkshire already owned the other 60%). What Berkshire "paid" was more than the net identifiable assets we received by \$51.7 million, and was assigned to two pieces of Goodwill: \$28.4 million to See's and \$23.3 million to Buffalo Evening News.

After the merger, therefore, Berkshire was left with a Goodwill asset for See's that had two components: the \$7.5 million remaining from the 1971 purchase, and \$28.4 million newly created by the 40% "purchased" in 1983. Our amortization charge now will be about \$1.0 million for the next 28 years, and \$.7 million for the following 12 years, 2002 through 2013.

In other words, different purchase dates and prices have given us vastly different asset values and amortization charges for two pieces of the same asset. (We repeat our usual disclaimer: we have no better accounting system to suggest. The problems to be dealt with are mind boggling and require arbitrary rules.)

But what are the **economic realities**? One reality is that the amortization charges that have been deducted as costs in the earnings statement each year since acquisition of See's were not true economic costs. We know that because See's last year earned \$13 million after taxes on about \$20 million of net tangible assets – a performance indicating the existence of economic Goodwill far larger than the total original cost of our accounting Goodwill. In other words, while accounting Goodwill regularly decreased from the moment of purchase, economic Goodwill increased in irregular but very substantial fashion.

Another reality is that annual amortization charges in the future will not correspond to economic costs. It is possible, of course, that See's economic Goodwill will disappear. But it won't shrink in even decrements

or anything remotely resembling them. **What is more likely is that the Goodwill will *increase* – in current, if not in constant, dollars – because of inflation.**

That probability exists because true economic Goodwill tends to rise in nominal value proportionally with inflation.⁴ To illustrate how this works, let's contrast a See's kind of business with a more mundane business. When we purchased See's in 1972, it will be recalled, it was earning about \$2 million on \$8 million of net tangible assets. Let us assume that our hypothetical mundane business then had \$2 million of earnings also, but needed \$18 million in net tangible assets for normal operations. Earning only 11% on required tangible assets, that mundane business would possess little or no economic Goodwill.

A business like that, therefore, might well have sold for the value of its net tangible assets, or for \$18 million. In contrast, we paid \$25 million for See's, even though it had no more in earnings and less than half as much in "honest-to-God" assets. Could less really have been more, as our purchase price implied? The answer is "yes" – *even if both businesses were expected to have flat unit volume* – as long as you anticipated, as we did in 1972, a world of continuous inflation.

To understand why, imagine the effect that a doubling of the price level would subsequently have on the two businesses. Both would need to double their nominal earnings to \$4 million to keep themselves even with inflation. This would seem to be no great trick: just sell the same number of units at double earlier prices and, assuming profit margins remain unchanged, profits also must double.

But, crucially, to bring that about, both businesses probably would have to double their nominal investment in net tangible assets, since that is the kind of economic requirement that inflation usually imposes on businesses, both good and bad. A doubling of dollar sales means correspondingly more dollars must be employed immediately in receivables and inventories. Dollars employed in fixed assets will respond more slowly to inflation, but probably just as surely. And all of this inflation-required investment will produce no improvement in rate of return. The motivation for this investment is the survival of the business, not the prosperity of the owner.

Remember, however, that **See's had net tangible assets of only \$8 million. So it would only have had to commit an additional \$8 million to finance the capital needs imposed by inflation. The mundane business, meanwhile, had a burden over twice as large – a need for \$18 million of additional capital.**

After the dust had settled, the mundane business, now earning \$4 million annually, might still be worth the value of its tangible assets, or \$36 million. That means its owners would have gained only a dollar of nominal value for every new dollar invested. (This is the same dollar-for-dollar result they would have achieved if they had added money to a savings account.)

See's, however, also earning \$4 million, might be worth \$50 million if valued (as it logically would be) on the same basis as it was at the time of our purchase. So it would have gained \$25 million in nominal value while the owners were putting up only \$8 million in additional capital – **over \$3 of nominal value gained for each \$1 invested.**

Remember, even so, that the owners of the See's kind of business were forced by inflation to ante up \$8 million in additional capital just to stay even in real profits. Any unleveraged business that requires some net tangible assets to operate (and almost all do) is hurt by inflation. Businesses needing little in the way of tangible assets simply are hurt the least.

And that fact, of course, has been hard for many people to grasp. For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with

⁴ Please see the article, *Inflation Swindles the Equity Investor* by Warren E. Buffett. Investors often confuse inflation protection with owning an asset-heavy business.

natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.

In contrast, a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses. This phenomenon has been particularly evident in the communications business. That business has required little in the way of tangible investment – yet its franchises have endured. During inflation, Goodwill is the gift that keeps giving.

But that statement applies, naturally, only to true economic Goodwill. Spurious accounting Goodwill – and there is plenty of it around – is another matter. When an overexcited management purchases a business at a silly price, the same accounting niceties described earlier are observed. Because it can't go anywhere else, the silliness ends up in the Goodwill account. Considering the lack of managerial discipline that created the account, under such circumstances it might better be labeled "No-Will". Whatever the term, the 40-year ritual typically is observed and the adrenalin so capitalized remains on the books as an "asset" just as if the acquisition had been a sensible one.

* * * * *

If you cling to any belief that accounting treatment of Goodwill is the best measure of economic reality, I suggest one final item to ponder.

Assume a company with \$20 per share of net worth, all tangible assets. Further assume the company has internally developed some magnificent consumer franchise, or that it was fortunate enough to obtain some important television stations by original FCC grant. Therefore, it earns a great deal on tangible assets, say \$5 per share, or 25%.

With such economics, it might sell for \$100 per share or more, and it might well also bring that price in a negotiated sale of the entire business.

Assume an investor buys the stock at \$100 per share, paying in effect \$80 per share for Goodwill (just as would a corporate purchaser buying the whole company). Should the investor impute a \$2 per share amortization charge annually (\$80 divided by 40 years) to calculate "true" earnings per share? And, if so, should the new "true" earnings of \$3 per share cause him to rethink his purchase price?

* * * * *

We believe managers and investors alike should view intangible assets from two perspectives:

1. In analysis of operating results – that is, in evaluating the underlying economics of a business unit – **amortization charges should be ignored.** What a business can be expected to earn on unleveraged net tangible assets, excluding any charges against earnings for amortization of Goodwill, is the best guide to the economic attractiveness of the operation. It is also the best guide to the current value of the operation's economic Goodwill.
2. In evaluating the wisdom of business acquisitions, amortization charges should be ignored also. They should be deducted neither from earnings nor from the cost of the business. This means forever viewing purchased Goodwill at its full cost, before any amortization. Furthermore, cost should be defined as including the full intrinsic business value – not just the recorded

accounting value – of all consideration given, irrespective of market prices of the securities involved at the time of merger and irrespective of whether pooling treatment was allowed. For example, what we truly paid in the Blue Chip merger for 40% of the Goodwill of See's and the News was considerably more than the \$51.7 million entered on our books. This disparity exists because the market value of the Berkshire shares given up in the merger was less than their intrinsic business value, which is the value that defines the true cost to us.

Operations that appear to be winners based upon perspective (1) may pale when viewed from perspective (2). **A good business is not always a good purchase (depends upon price) – although it's a good place to look for one.**

We will try to acquire businesses that have excellent operating economics measured by (1) and that provide reasonable returns measured by (2) Accounting consequences will be totally ignored.

At yearend 1983, net Goodwill on our accounting books totaled \$62 million, consisting of the \$79 million you see stated on the asset side of our balance sheet, and \$17 million of negative Goodwill that is offset against the carrying value of our interest in Mutual Savings and Loan.

We believe net economic Goodwill far exceeds the \$62 million accounting number.

--

See's Candy Shops

The financial results at See's continue to be exceptional. The business possesses a valuable and solid consumer franchise and a manager equally valuable and solid.

In recent years See's has encountered two important problems, at least one of which is well on its way toward solution. That problem concerns costs, except those for raw materials. We have enjoyed a break on raw material costs in recent years though so, of course, have our competitors. One of these days we will get a nasty surprise in the opposite direction. In effect, raw material costs are largely beyond our Control, since we will, as a matter of course, buy the finest ingredients that we can, regardless of changes in their price levels. **We regard product quality as sacred.**

But other kinds of costs are more controllable, and it is in this area that we have had problems. On a per-pound basis, our costs (not including those for raw materials) have increased in the last few years at a rate significantly greater than the increase in the general price level. It is vital to our competitive position and profit potential that we reverse this trend.

In recent months much better control over costs has been attained and we feel certain that our rate of growth in these costs in 1984 will be below the rate of inflation. This confidence arises out of our long experience with the managerial talents of Chuck Huggins. We put Chuck in charge the day we took over, and his record has been simply extraordinary, as shown by the following table:

52-53 Week Year Ended About December 31	Sales Revenues	Operating Profits After Taxes	Number of Pounds of Candy Sold	Number of Stores Open at Year End
1983 (53 weeks) ...	\$133,531,000	\$13,699,000	24,651,000	207
1982	123,662,000	11,875,000	24,216,000	202
1981	112,578,000	10,779,000	24,052,000	199
1980	97,715,000	7,547,000	24,065,000	191

1979	87,314,000	6,330,000	23,985,000	188
1978	73,653,000	6,178,000	22,407,000	182
1977	62,886,000	6,154,000	20,921,000	179
1976 (53 weeks)	56,333,000	5,569,000	20,553,000	173
1975	50,492,000	5,132,000	19,134,000	172
1974	41,248,000	3,021,000	17,883,000	170
1973	35,050,000	1,940,000	17,813,000	169
1972	31,337,000	2,083,000	16,954,000	167

The other problem we face, as the table suggests, is our recent inability to achieve meaningful gains in pounds sold. The industry has the same problem. But for many years we outperformed the industry in this respect and now we are not.

The poundage volume in our retail stores has been virtually unchanged each year for the past four, despite small increases every year in the number of shops (and in distribution expense as well). Of course, dollar volume has increased because **we have raised prices significantly**. But we regard the most important measure of retail trends to be **units sold per store** rather than dollar volume. On a same-store basis (counting only shops open throughout both years) with all figures adjusted to a 52-week year, poundage was down .8 of 1% during 1983. This small decline was our best same-store performance since 1979; the cumulative decline since then has been about 8%. Quantity-order volume, about 25% of our total, has plateaued in recent years following very large poundage gains throughout the 1970s.

We are not sure to what extent this flat volume - both in the retail shop area and the quantity order area - is due to our pricing policies and to what extent it is due to static industry volume, the recession, and the extraordinary share of market we already enjoy in our primary marketing area. Our price increase for 1984 is much more modest than has been the case in the past few years, and we hope that next year we can report better volume figures to you. But we have no basis to forecast these.

Despite the volume problem, See's strengths are many and important. In our primary marketing area, the West, our candy is preferred by an enormous margin to that of any competitor. In fact, we believe most lovers of chocolate prefer it to candy costing two or three times as much. (In candy, as in stocks, price and value can differ; price is what you give, value is what you get.) The quality of customer service in our shops - operated throughout the country by us and not by franchisees is every bit as good as the product. Cheerful, helpful personnel are as much a trademark of See's as is the logo on the box. That's no small achievement in a business that requires us to hire about 2000 seasonal workers. We know of no comparably-sized organization that betters the quality of customer service delivered by Chuck Huggins and his associates.

Because we have raised prices so modestly in 1984, we expect See's profits this year to be about the same as in 1983.

--

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1986 was \$492.5 million, or 26.1%.

o At See's, sales trends improved somewhat from those of recent years. Total pounds sold rose about 2%. (For you chocaholics who like to fantasize, one statistic: we sell over 12,000 tons annually.) **Same-store sales, measured in pounds, were virtually unchanged.** In the previous six years, same store

poundage fell, and we gained or maintained poundage volume only by adding stores. But a particularly strong Christmas season in 1986 stemmed the decline. By stabilizing same-store volume and making a major effort to control costs, See's was able to maintain its excellent profit margin in 1986 though it put through only minimal price increases. We have Chuck Huggins, our long-time manager at See's, to thank for this significant achievement.

See's has a one-of-a-kind product "personality" produced by a combination of its candy's delicious taste and moderate price, the company's total control of the distribution process, and the exceptional service provided by store employees. Chuck rightfully measures his success by the satisfaction of our customers, and his attitude permeates the organization. Few major retailing companies have been able to sustain such a customer-oriented spirit, and we owe Chuck a great deal for keeping it alive and well at See's.

See's profits should stay at about their present level. We will continue to increase prices very modestly, merely matching prospective cost increases.

Appendix

Purchase-Price Accounting Adjustments and the "Cash Flow" Fallacy

First a short quiz: below are abbreviated 1986 statements of earnings for two companies. Which business is the more valuable?

	<u>Company O</u>	<u>Company N</u> (000s Omitted)
Revenues.....	\$677,240	\$677,240
Costs of Goods Sold:		
Historical costs, excluding depreciation.....	\$341,170	\$341,170
Special non-cash inventory costs.....		4,979 ⁽¹⁾
Depreciation of plant and equipment	8,301	13,355 ⁽²⁾
	<u>349,471</u>	<u>359,504</u>
	\$327,769	\$317,736
Gross Profit		
Selling & Admin. Expense.....	\$260,286	\$260,286
Amortization of Goodwill	_____	<u>595</u> ⁽³⁾
	<u>260,286</u>	<u>260,881</u>
Operating Profit	\$ 67,483	\$ 56,855
Other Income, Net	<u>4,135</u>	<u>4,135</u>
Pre-Tax Income	\$ 71,618	\$ 60,990
Applicable Income Tax:		
Historical deferred and current tax	\$ 31,387	\$ 31,387
Non-Cash Inter-period Allocation Adjustment	_____	<u>998</u> ⁽⁴⁾
	<u>31,387</u>	<u>32,385</u>
Net Income	<u>\$40,231</u> =====	\$28,605 =====

(Numbers (1) through (4) designate items discussed later in this section.)

As you've probably guessed, Companies O and N are the same business - Scott Fetzer. In the "O" (for "old") column we have shown what the company's 1986 GAAP earnings would have been if we had not purchased it; in the "N" (for "new") column we have shown Scott Fetzer's GAAP earnings as actually reported by Berkshire.

It should be emphasized that the two columns depict identical economics - i.e., the same sales, wages, taxes, etc. And both "companies" generate the same amount of cash for owners. Only the accounting is different.

So, fellow philosophers, which column presents truth? Upon which set of numbers should managers and investors focus?

Before we tackle those questions, let's look at what produces the disparity between O and N. We will simplify our discussion in some respects, but the simplification should not produce any inaccuracies in analysis or conclusions.

The contrast between O and N comes about because we paid an amount for Scott Fetzer that was different from its stated net worth. Under GAAP, such differences - such premiums or discounts - must be accounted for by "purchase-price adjustments." In Scott Fetzer's case, we paid \$315 million for net assets that were carried on its books at \$172.4 million. So we paid a premium of \$142.6 million.

The first step in accounting for any premium paid is to adjust the carrying value of current assets to current values. In practice, this requirement usually does not affect receivables, which are routinely carried at current value, but often affects inventories. Because of a \$22.9 million LIFO reserve and other accounting intricacies, Scott Fetzer's inventory account was carried at a \$37.3 million discount from current value. So, making our first accounting move, we used \$37.3 million of our \$142.6 million premium to increase the carrying value of the inventory.

Assuming any premium is left after current assets are adjusted, the next step is to adjust fixed assets to current value. In our case, this adjustment also required a few accounting acrobatics relating to deferred taxes. Since this has been billed as a simplified discussion, I will skip the details and give you the bottom line: \$68.0 million was added to fixed assets and \$13.0 million was eliminated from deferred tax liabilities. After making this \$81.0 million adjustment, we were left with \$24.3 million of premium to allocate.

Had our situation called for them two steps would next have been required: the adjustment of intangible assets other than Goodwill to current fair values, and the restatement of liabilities to current fair values, a requirement that typically affects only long-term debt and unfunded pension liabilities. In Scott Fetzer's case, however, neither of these steps was necessary.

The final accounting adjustment we needed to make, after recording fair market values for all assets and liabilities, was the assignment of the residual premium to Goodwill (technically known as "excess of cost over the fair value of net assets acquired"). This residual amounted to \$24.3 million. Thus, the balance sheet of Scott Fetzer immediately before the acquisition, which is summarized below in column O, was transformed by the purchase into the balance sheet shown in column N. In real terms, both balance sheets depict the same assets and liabilities - but, as you can see, certain figures differ significantly.

	<u>Company O</u>	<u>Company N</u>
	(000s Omitted)	
Assets		
Cash and Cash Equivalents	\$ 3,593	\$ 3,593
Receivables, net	90,919	90,919
Inventories	77,489	114,764
Other	<u>5,954</u>	<u>5,954</u>
Total Current Assets	177,955	215,230
Property, Plant, and Equipment, net	80,967	148,960
Investments in and Advances to Unconsolidated Subsidiaries and Joint Ventures	93,589	93,589
Other Assets, including Goodwill	<u>9,836</u>	<u>34,210</u>
	<u>\$362,347</u>	<u>\$491,989</u>
Liabilities		
Notes Payable and Current Portion of Long- term Debt	\$ 4,650	\$ 4,650
Accounts Payable.....	39,003	39,003
Accrued Liabilities.....	<u>84,939</u>	<u>84,939</u>
Total Current Liabilities.....	128,592	128,592
Long-term Debt and Capitalized Leases.....	34,669	34,669
Deferred Income Taxes.....	17,052	4,075
Other Deferred Credits.....	<u>9,657</u>	<u>9,657</u>
Total Liabilities.....	189,970	176,993
Shareholders' Equity	<u>172,377</u>	<u>314,996</u>
	<u>\$362,347</u>	<u>\$491,989</u>

The higher balance sheet figures shown in column N produce the lower income figures shown in column N of the earnings statement presented earlier. This is the result of the asset write-ups and of the fact that some of the written-up assets must be depreciated or amortized. The higher the asset figure, the higher the annual depreciation or amortization charge to earnings must be. The charges that flowed to the earnings statement because of the balance sheet write-ups were numbered in the statement of earnings shown earlier:

1. \$4,979,000 for non-cash inventory costs resulting, primarily, from reductions that Scott Fetzer made in its inventories during 1986; charges of this kind are apt to be small or non-existent in future years.
2. \$5,054,000 for extra depreciation attributable to the write-up of fixed assets; a charge approximating this amount will probably be made annually for 12 more years.
3. \$595,000 for amortization of Goodwill; this charge will be made annually for 39 more years in a slightly larger amount because our purchase was made on January 6 and, therefore, the 1986 figure applies to only 98% of the year.
4. \$998,000 for deferred-tax acrobatics that are beyond my ability to explain briefly (or perhaps even non-briefly); a charge approximating this amount will probably be made annually for 12 more years.

It is important to understand that none of these newly-created accounting costs, totaling \$11.6 million, are deductible for income tax purposes. The "new" Scott Fetzer pays exactly the same tax as the "old" Scott Fetzer would have, even though the GAAP earnings of the two entities differ greatly. And, in respect to operating earnings, that would be true in the future also. However, in the unlikely event that Scott Fetzer sells one of its businesses, the tax consequences to the "old" and "new" company might differ widely.

By the end of 1986 the difference between the net worth of the "old" and "new" Scott Fetzer had been reduced from \$142.6 million to \$131.0 million by means of the extra \$11.6 million that was charged to earnings of the new entity. As the years go by, similar charges to earnings will cause most of the premium to disappear, and the two balance sheets will converge. However, the higher land values and most of the higher inventory values that were established on the new balance sheet will remain unless land is disposed of or inventory levels are further reduced.

* * *

What does all this mean for owners? Did the shareholders of Berkshire buy a business that earned \$40.2 million in 1986 or did they buy one earning \$28.6 million? Were those \$11.6 million of new charges a real economic cost to us? Should investors pay more for the stock of Company O than of Company N? And, if a business is worth some given multiple of earnings, was Scott Fetzer worth considerably more the day before we bought it than it was worth the following day?

If we think through these questions, we can gain some insights about what may be called "**owner earnings**." These represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges such as Company N's items (1) and (4) less **c** the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume. (If the business requires additional working capital to maintain its competitive position and unit volume, the increment also should be included in **c**.) However, businesses following the LIFO inventory method usually do not require additional working capital if unit volume does not change.)

Our owner-earnings equation does not yield the deceptively precise figures provided by GAAP, since **c** must be a guess - and one sometimes very difficult to make. Despite this problem, we consider the

owner earnings figure, not the GAAP figure, to be the relevant item for valuation purposes - both for investors in buying stocks and for managers in buying entire businesses. We agree with Keynes's observation: "I would rather be vaguely right than precisely wrong."

The approach we have outlined produces "owner earnings" for Company O and Company N that are identical, which means valuations are also identical, just as common sense would tell you should be the case. This result is reached because the sum of (a) and (b) is the same in both columns O and N, and because c is necessarily the same in both cases.

And what do Charlie and I, as owners and managers, believe is the correct figure for the owner earnings of Scott Fetzer? Under current circumstances, we believe c is very close to the "old" company's (b) number of \$8.3 million and much below the "new" company's (b) number of \$19.9 million. Therefore, we believe that owner earnings are far better depicted by the reported earnings in the O column than by those in the N column. In other words, we feel owner earnings of Scott Fetzer are considerably larger than the GAAP figures that we report.

That is obviously a happy state of affairs. But calculations of this sort usually do not provide such pleasant news. Most managers probably will acknowledge that they need to spend something more than (b) on their businesses over the longer term just to hold their ground in terms of both unit volume and competitive position. When this imperative exists - that is, when c exceeds (b) - GAAP earnings overstate owner earnings. Frequently this overstatement is substantial. The oil industry has in recent years provided a conspicuous example of this phenomenon. Had most major oil companies spent only (b) each year, they would have guaranteed their shrinkage in real terms.

All of this points up the absurdity of the "cash flow" numbers that are often set forth in Wall Street reports.⁵ These numbers routinely include (a) plus (b) - but do not subtract c . Most sales brochures of investment bankers also feature deceptive presentations of this kind. These imply that the business being offered is the commercial counterpart of the Pyramids - forever state-of-the-art, never needing to be replaced, improved or refurbished. Indeed, if all U.S. corporations were to be offered simultaneously for sale through our leading investment bankers - and if the sales brochures describing them were to be believed - governmental projections of national plant and equipment spending would have to be slashed by 90%.

"Cash Flow", true, may serve as shorthand of some utility in descriptions of certain real estate businesses or other enterprises that make huge initial outlays and only tiny outlays thereafter. A company whose only holding is a bridge or an extremely long-lived gas field would be an example. But "cash flow" is meaningless in such businesses as manufacturing, retailing, extractive companies, and utilities because, for them, c is always significant. To be sure, businesses of this kind may in a given year be able to defer capital spending. But over a five- or ten-year period, they must make the investment - or the business decays.

Why, then, are "cash flow" numbers so popular today? In answer, we confess our cynicism: we believe these numbers are frequently used by marketers of businesses and securities in attempts to justify the unjustifiable (and thereby to sell what should be the unsalable). When (a) - that is, GAAP earnings - looks by itself inadequate to service debt of a junk bond or justify a foolish stock price, how convenient it becomes for salesmen to focus on (a) + (b). But you shouldn't add (b) without subtracting c : though dentists correctly claim that if you ignore your teeth they'll go away, the same is not true for c . The company or investor believing that the debt-servicing ability or the equity valuation of an enterprise can be measured by totaling (a) and (b) while ignoring c is headed for certain trouble.

* * *

⁵ See *Placing EBIDA into Perspective*

To sum up: in the case of both Scott Fetzer and our other businesses, we feel that (b) on an historical-cost basis - i.e., with both amortization of intangibles and other purchase-price adjustments excluded - is quite close in amount to □ c□ . (The two items are not identical, of course. For example, at See's we annually make capitalized expenditures that exceed depreciation by \$500,000 to \$1 million, simply to hold our ground competitively.) Our conviction about this point is the reason we show our amortization and other purchase-price adjustment items separately in the table on page 8 and is also our reason for viewing the earnings of the individual businesses as reported there as much more closely approximating owner earnings than the GAAP figures.

Questioning GAAP figures may seem impious to some. After all, what are we paying the accountants for if it is not to deliver us the "truth" about our business. But the accountants' job is to record, not to evaluate. The evaluation job falls to investors and managers.

Accounting numbers, of course, are the language of business and as such are of enormous help to anyone evaluating the worth of a business and tracking its progress. Charlie and I would be lost without these numbers: they invariably are the starting point for us in evaluating our own businesses and those of others. Managers and owners need to remember, however, that accounting is but an aid to business thinking, never a substitute for it.

--

To the Shareholders of Berkshire Hathaway Inc.:

First, a few words about accounting. The merger with Diversified Retailing Company, Inc. at yearend adds two new complications in the presentation of our financial results. After the merger, our ownership of Blue Chip Stamps increased to approximately 58% and, therefore, the accounts of that company must be fully consolidated in the Balance Sheet and Statement of Earnings presentation of Berkshire. In previous reports, our share of the net earnings only of Blue Chip had been included as a single item on Berkshire's Statement of Earnings, and there had been a similar one-line inclusion on our Balance Sheet of our share of their net assets.

This full consolidation of sales, expenses, receivables, inventories, debt, etc. produces an aggregation of figures from many diverse businesses - textiles, insurance, candy, newspapers, and trading stamps - with dramatically different economic characteristics. In some of these your ownership is 100% but, in those businesses which are owned by Blue Chip but fully consolidated, your ownership as a Berkshire shareholder is only 58%. (Ownership by others of the balance of these businesses is accounted for by the large minority interest item on the liability side of the Balance Sheet.) **Such a grouping of Balance Sheet and Earnings items - some wholly owned, some partly owned - tends to obscure economic reality more than illuminate it.** In fact, it represents a form of presentation that we never prepare for internal use during the year and which is of no value to us in any management activities.

For that reason, throughout the report we provide much separate financial information and commentary on the various segments of the business to help you evaluate Berkshire's performance and prospects. Much of this segmented information is mandated by SEC disclosure rules and covered in "Management's Discussion" on pages 29 to 34. And in this letter we try to present to you a view of our various operating entities from the same perspective that we view them managerially.

A second complication arising from the merger is that the 1977 figures shown in this report are different from the 1977 figures shown in the report we mailed to you last year. Accounting convention requires that when two entities such as Diversified and Berkshire are merged, all financial data subsequently must be presented as if the companies had been merged at the time they were formed rather than just recently. So the enclosed financial statements, in effect, pretend that in 1977 (and earlier years) the Diversified-Berkshire merger already had taken place, even though the actual merger date was December 30, 1978. This shifting base makes comparative commentary confusing and, from time to time in our narrative report, we will talk of figures and performance for Berkshire shareholders as

historically reported to you rather than as restated after the Diversified merger.

--

1984 Share repurchases (A Lesson in Corporate Finance)

The companies in which we have our largest investments have all engaged in significant stock repurchases at times when wide discrepancies existed between price and value. As shareholders, we find this encouraging and rewarding for two important reasons - one that is obvious, and one that is subtle and not always understood. The obvious point involves basic arithmetic: major repurchases at prices well below per-share intrinsic business value immediately increase, in a highly significant way, that value. When companies purchase their own stock, they often find it easy to get \$2 of present value for \$1. Corporate acquisition programs almost never do as well and, in a discouragingly large number of cases, fail to get anything close to \$1 of value for each \$1 expended.

The other benefit of repurchases is less subject to precise measurement but can be fully as important over time. By making repurchases when a company's market value is well below its business value, management clearly demonstrates that it is given to actions that enhance the wealth of shareholders, rather than to actions that expand management's domain but that do nothing for (or even harm) shareholders. Seeing this, shareholders and potential shareholders increase their estimates of future returns from the business. This upward revision, in turn, produces market prices more in line with intrinsic business value. These prices are entirely rational. Investors should pay more for a business that is lodged in the hands of a manager with demonstrated pro-shareholder leanings than for one in the hands of a self-interested manager marching to a different drummer. (To make the point extreme, how much would you pay to be a minority shareholder of a company controlled by Robert Wesco?)

The key word is "demonstrated". A manager who consistently turns his back on repurchases, when these clearly are in the interests of owners, reveals more than he knows of his motivations. No matter how often or how eloquently he mouths some public relations-inspired phrase such as "maximizing shareholder wealth" (this season's favorite), the market correctly discounts assets lodged with him. His heart is not listening to his mouth - and, after a while, neither will the market.

1984 Dividend Policy

Dividend policy is often reported to shareholders, but seldom explained. A company will say something like, "Our goal is to pay out 40% to 50% of earnings and to increase dividends at a rate at least equal to the rise in the CPI". And that's it - no analysis will be supplied as to why that particular policy is best for the owners of the business. Yet, allocation of capital is crucial to business and investment management. Because it is, we believe managers and owners should think hard about the circumstances under which earnings should be retained and under which they should be distributed.

The first point to understand is that all earnings are not created equal. In many businesses particularly those that have high asset/profit ratios - inflation causes some or all of the reported earnings to become ersatz. The ersatz portion - let's call these earnings "restricted" - cannot, if the business is to retain its economic position, be distributed as dividends. Were these earnings to be paid out, the business would lose ground in one or more of the following areas: its ability to maintain its unit volume of sales, its long-term competitive position, and its financial strength. No matter how conservative its payout ratio, a company that consistently distributes restricted earnings is destined for oblivion unless equity capital is otherwise infused.

Restricted earnings are seldom valueless to owners, but they often must be discounted heavily. In effect, they are conscripted by the business, no matter how poor its economic potential. (This retention-no-matter-how-unattractive-the-return situation was communicated unwittingly in a marvelously ironic way by Consolidated Edison a decade ago. At the time, a punitive regulatory policy was a major

factor causing the company's stock to sell as low as one-fourth of book value; i.e., every time a dollar of earnings was retained for reinvestment in the business, that dollar was transformed into only 25 cents of market value. But, despite this gold-into-lead process, most earnings were reinvested in the business rather than paid to owners. Meanwhile, at construction and maintenance sites throughout New York, signs proudly proclaimed the corporate slogan, "**Dig We Must**".)

Restricted earnings need not concern us further in this dividend discussion. Let's turn to the much-more-valued unrestricted variety. These earnings may, with equal feasibility, be retained or distributed. In our opinion, management should choose whichever course makes greater sense for the owners of the business.

This principle is not universally accepted. For a number of reasons managers like to withhold unrestricted, readily distributable earnings from shareholders - to expand the corporate empire over which the managers rule, to operate from a position of exceptional financial comfort, etc. But we believe there is only one valid reason for retention. Unrestricted earnings should be retained only when there is a reasonable prospect - backed preferably by historical evidence or, when appropriate, by a thoughtful analysis of the future - that *for every dollar retained by the corporation, at least one dollar of market value will be created for owners*. This will happen only if the capital retained produces incremental earnings equal to, or above, those generally available to investors.

To illustrate, let's assume that an investor owns a risk-free 10% perpetual bond with one very unusual feature. Each year the investor can elect either to take his 10% coupon in cash, or to reinvest the coupon in more 10% bonds with identical terms; i.e., a perpetual life and coupons offering the same cash-or-reinvest option. If, in any given year, the prevailing interest rate on long-term, risk-free bonds is 5%, it would be foolish for the investor to take his coupon in cash since the 10% bonds he could instead choose would be worth considerably more than 100 cents on the dollar. Under these circumstances, the investor wanting to get his hands on cash should take his coupon in additional bonds and then immediately sell them. By doing that, he would realize more cash than if he had taken his coupon directly in cash. Assuming all bonds were held by rational investors, no one would opt for cash in an era of 5% interest rates, not even those bondholders needing cash for living purposes.

If, however, interest rates were 15%, no rational investor would want his money invested for him at 10%. Instead, the investor would choose to take his coupon in cash, even if his personal cash needs were nil. The opposite course - reinvestment of the coupon - would give an investor additional bonds with market value far less than the cash he could have elected. If he should want 10% bonds, he can simply take the cash received and buy them in the market, where they will be available at a large discount.

An analysis similar to that made by our hypothetical bondholder is appropriate for owners in thinking about whether a company's unrestricted earnings should be retained or paid out. Of course, the analysis is much more difficult and subject to error because the rate earned on reinvested earnings is not a contractual figure, as in our bond case, but rather a fluctuating figure. Owners must guess as to what the rate will average over the intermediate future. However, once an informed guess is made, the rest of the analysis is simple: you should wish your earnings to be reinvested if they can be expected to earn high returns, and you should wish them paid to you if low returns are the likely outcome of reinvestment.

Many corporate managers reason very much along these lines in determining whether subsidiaries should distribute earnings to their parent company. At that level, the managers have no trouble thinking like intelligent owners. But payout decisions at the parent company level often are a different story. Here managers frequently have trouble putting themselves in the shoes of their shareholder-owners.

With this schizoid approach, the CEO of a multi-divisional company will instruct Subsidiary A, whose earnings on incremental capital may be expected to average 5%, to distribute all available earnings in order that they may be invested in Subsidiary B, whose earnings on incremental capital are expected to be 15%. The CEO's business school oath will allow no lesser behavior. But if his own long-term record with incremental capital is 5% - and market rates are 10% - he is likely to impose a dividend policy

on shareholders of the parent company that merely follows some historical or industry-wide payout pattern.

Furthermore, he will expect managers of subsidiaries to give him a full account as to why it makes sense for earnings to be retained in their operations rather than distributed to the parent-owner. But seldom will he supply his owners with a similar analysis pertaining to the whole company.

In judging whether managers should retain earnings, shareholders should not simply compare total incremental earnings in recent years to total incremental capital because that relationship may be distorted by what is going on in a core business. During an inflationary period, companies with a core business characterized by extraordinary economics can use small amounts of incremental capital in that business at very high rates of return (as was discussed in last year's section on Goodwill). But, unless they are experiencing tremendous unit growth, outstanding businesses by definition generate large amounts of excess cash. If a company sinks most of this money in other businesses that earn low returns, the company's overall return on retained capital may nevertheless appear excellent because of the extraordinary returns being earned by the portion of earnings incrementally invested in the core business. The situation is analogous to a Pro-Am golf event: even if all of the amateurs are hopeless duffers, the team's best-ball score will be respectable because of the dominating skills of the professional.

Many corporations that consistently show good returns both on equity and on overall incremental capital have, indeed, employed a large portion of their retained earnings on an economically unattractive, even disastrous, basis. Their marvelous core businesses, however, whose earnings grow year after year, camouflage repeated failures in capital allocation elsewhere (usually involving high-priced acquisitions of businesses that have inherently mediocre economics). The managers at fault periodically report on the lessons they have learned from the latest disappointment. They then usually seek out future lessons. (Failure seems to go to their heads.)

In such cases, shareholders would be far better off if earnings were retained only to expand the high-return business, with the balance paid in dividends or used to repurchase stock (an action that increases the owners' interest in the exceptional business while sparing them participation in subpar businesses). Managers of high-return businesses who consistently employ much of the cash thrown off by those businesses in other ventures with low returns should be held to account for those allocation decisions, regardless of how profitable the overall enterprise is.

Nothing in this discussion is intended to argue for dividends that bounce around from quarter to quarter with each wiggle in earnings or in investment opportunities. Shareholders of public corporations understandably prefer that dividends be consistent and predictable. Payments, therefore, should reflect long-term expectations for both earnings and returns on incremental capital. Since the long-term corporate outlook changes only infrequently, dividend patterns should change no more often. But over time distributable earnings that have been withheld by managers should earn their keep. If earnings have been unwisely retained, it is likely that managers, too, have been unwisely retained.

Let's now turn to Berkshire Hathaway and examine how these dividend principles apply to it. Historically, Berkshire has earned well over market rates on retained earnings, thereby creating over one dollar of market value for every dollar retained. Under such circumstances, any distribution would have been contrary to the financial interest of shareholders, large or small.

In fact, significant distributions in the early years might have been disastrous, as a review of our starting position will show you. Charlie and I then controlled and managed three companies, Berkshire Hathaway Inc., Diversified Retailing Company, Inc., and Blue Chip Stamps (all now merged into our present operation). Blue Chip paid only a small dividend, Berkshire and DRC paid nothing. If, instead, the companies had paid out their entire earnings, we almost certainly would have no earnings at all now - and perhaps no capital as well. The three companies each originally made their money from a single business: (1) textiles at Berkshire; (2) department stores at Diversified; and (3) trading stamps at Blue Chip. These cornerstone businesses (carefully chosen, it should be noted, by your Chairman and Vice Chairman) have, respectively, (1) survived but earned almost nothing, (2) shriveled in size while incurring

large losses, and (3) shrunk in sales volume to about 5% its size at the time of our entry. (Who says “you can’t lose ‘em all”?) Only by committing available funds to much better businesses were we able to overcome these origins. (It’s been like overcoming a misspent youth.) Clearly, diversification has served us well.

We expect to continue to diversify while also supporting the growth of current operations though, as we’ve pointed out, our returns from these efforts will surely be below our historical returns. But as long as prospective returns are above the rate required to produce a dollar of market value per dollar retained, we will continue to retain all earnings. Should our estimate of future returns fall below that point, we will distribute all unrestricted earnings that we believe cannot be effectively used. In making that judgment, we will look at both our historical record and our prospects. Because our year-to-year results are inherently volatile, we believe a five-year rolling average to be appropriate for judging the historical record.

Our present plan is to use our retained earnings to further build the capital of our insurance companies. Most of our competitors are in weakened financial condition and reluctant to expand substantially. Yet large premium-volume gains for the industry are imminent, amounting probably to well over \$15 billion in 1985 versus less than \$5 billion in 1983. These circumstances could produce major amounts of profitable business for us. Of course, this result is no sure thing, but prospects for it are far better than they have been for many years.

--

Buffett conversation on economic Goodwill (pages 801-802 in *Cardozo Law Review, Vol. 19, and Numbers 1-2 for Sept.-Nov. 1997*)

Buffett: In most cases I would say the premium we pay above the net assets recorded on the books of the predecessor company overwhelmingly is for what we call economic goodwill. We don’t even look at the plants. We did not look at the plants of Scott Fetzer before we bought it. We did not look at the plants of H.H. Brown before we bought it. I have not looked at the plants since—I have never seen the plants at H.H. Brown. **We don’t think in terms of appraising physical assets.**

We think in terms of economic goodwill. We believe that economic goodwill should all be placed on the balance sheet as a purchase. We even think that if we give stock that has greater intrinsic value, that it ought to be placed on at a higher price than market price.

In terms of the inventory on World Book we LIFO, so we are always charging current costs out—we have not had any LIFO, so we are always charging current costs out—we have not had any LIFO reduction that has caused any of that to flow into income. We use current costs on a LIFO basis-obviously last in is first out and that’s been reflected.

If we had our choice in accounting for Scott Fetzer—which we didn’t have, first you had to allocate to certain assets the premium we paid and the residual is goodwill—we would say it is all goodwill. The plant account of Scott Fetzer on their books before purchase accounting adjustments straight through—the plant account is less now that it was when we bought the firm. So, essentially we have not been faced with the problem of the fact that the replacement value is much higher. The plant account is \$49 million now—it was considerably more before, plus it makes more money.

What we were buying was economic goodwill. Fortunately, the economic goodwill has not deteriorated at Scott Fetzer. In our view, to attribute \$50 million of the purchase price, let’s say to plant and equipment—if someone tells us that is the replacement value---that just isn’t the

way we look at it. Now we may be required to put it on our books that way but we also want to tell shareholders how we look at it.

--

Question:I agree with you that goodwill should be non-amortizable. But there wasn't much goodwill in the World Book acquisition so that the premium purchase price, over Scott Fetzer's books, was really all allocable to the **plant and equipment** accounts.

Buffett:

We did it as required. In our view, it was all goodwill, but it was required to be broken down based on FIFO value of inventory, appraised value of property, plant and equipment, and residuals and some if it went to **deferred tax liabilities**.

What we are telling shareholders is those are the rules we follow, but in our view we paid the entire premium for goodwill. We also thought that the goodwill would not depreciate in value of else we would not have bought it in the first place. And that was the way we would keep the books. But it isn't the way the books were being kept so we explained what we thought.

.....We find financial information—even as presented—is enormously useful. And we have bought in the last year and a half four businesses—when all we had was financial information plus our ability to think some about the economic characteristics. We accept--I shouldn't say we accept precisely the numbers--**but the numbers as given to us from GAAP accounting are of sufficient utility to us so that we can make a judgment about buying a business without ever seeing whether a plant exists.**

END