Warren Buffett and Accounting in Favor of Investors

Calvin Johnson*

Introduction: Framework

<u>Servant of the Market</u>. Financial accounting is the servant of the efficient market. The function of the audited financial statements provided to shareholders and to the public is to help investors allocate capital to the best investments with as low transaction costs as possible. To run an efficient market, the traders and investors have to have fast, accurate and reliable information relevant to their investment decision. The higher the transaction costs of acquiring information, the greater will be the gap between the price and the real value of a stock. When the stock price indicators depart from real values, capital is misallocated and misused.

<u>Johnson Weed</u>. To have a public market, you need to enforce standards of grading. You can not, for instance, run a commodities exchange in wheat futures unless someone is grading the wheat and keeping the Johnson Weed out of the wheat bushels. I have heard farmers complain bitterly that it is too expensive to keep the Johnson Weed out of the wheat field and that the penalty in terms of grading is unjustly harsh for the harm that the Johnson Weed does. Johnson Weed is just not that bitter. But grading has to be quick and standardized. Commodities have to be fungible and the grades have to assumed by the traders acting quickly. You can not make fine judgments about the gradations of Johnson Weed in a bushel when you are trading in a minimum unit of 20 metric tons. So similarly, you can not run a national stock market unless someone is maintaining the standards by which the stock is graded. Without standards, the stock market will become like the real estate market, with slow trades, lots of inspections and 6% broker's commissions on both sides.

<u>Sole Client is the Market</u>. The market is the only client of public accounting. Accountants' loyalty to the market must trump their loyalty to management of the firm, who selects and pays them. Loyalty to the market needs to be brutally enforced. It is only when the accounting reports improve the allocation of capital by investors that public accountants earn their pay. Accountants owe no duty to the firm -- in the game of audit, the accountant is the cops and management is the robbers. If management gets any benefit from an audit, it is only in so far as serving the market serves the nation as a whole.

---

* University of Texas Law School

Other Kinds of Accounting. Accounting provided for management's own use is called cost accounting or division reports or anything that management wants to call it, other than "financial accounting." Accounting provided for creditors is called a "loan application," "credit report," or "indenture accounting" or anything the creditor wants to call it, other than "financial accounting." Almost any double-entry bookkeeping will provide for "stewardship accounting" so long as you can trace the accounts and see where the money should be. "Financial accounting," however, is solely for the good of the market.

Accounting Wars. Accounting, nonetheless, is war. Every firm tries to spin the market value of its stock and to use financial reports like advertising to pull in investors. Management wins too many battles -- more than is good for God and Country. There has, for instance, been a revolution in financial information and analysis over the last twenty years. Meanwhile, the Financial Accounting Standards Board (FASB) is still struggling with the "net present value" concept, as if it were a hard issue, and struggling hard to avoid the unfathomable difficulties of the concept of "market" as in "fair market value" or "mark to market."[1] Financial Accounting Standards use old fashion financial concepts that make life very much easier for management and auditors and very much harder for outside investors. The old fashion financial analysis degrades the quality of available information. FASB has also made a number of specific decisions in recent years intended to solve management problems, but not to help allocate capital. What is needed in financial accounting is data that serves real investors on real investment decisions. I suspect that the current Financial Accounting Standards Board will never get there, under current institutional arrangements. Management influence is just too strong.

Tighter capture? The Financial Executives Institute has called for tighter management control over FASB. Some would go further and disband FASB and the SEC. FASB is (quasi) government regulation.

Worsen investments. Free market accounting, however, is not going to improve the allocation of capital. Well organized insiders, with all the control of information, will eat disorganized investors for lunch. Insiders will just increase their rents extracted from the market by their very favorable position. Deregulating

[1] *Cf.* Dennis Beresford and John Hepp, *Financial Statement Disclosures: Too Many or Too Few?*, FASB STATUS REPORT NO. 264, 7, @ (May 25, 1995)(geometric increase in available financial information and analysis to help management decisions in recent years has not been extended to outside investors and creditors)

accounting will not improve the efficiency of the market, the quality of information or the allocation of capital. Improving accounting information will improve investing, even if management is badly hurt.

Buffett's Role. Warren Buffett has sometimes been an ally of investors in the accounting wars. He does do a fair amount of investing. Buffett has been articulate in arguing that stock options are compensation, properly included in expense. But Buffett is a wavering ally and, as often as not, he is tempted over to the dark side, trying to accomplish some pro-management spin. Buffett, for instance, has been arguing that Berkshire Hathaway should not have to use "purchase accounting" for its acquisition, which goes back to 1970 accounting battles and reruns them to let the management side win. Finally, Buffett seem to want to shoehorn financial earnings into the mold of a perpetuity or constant percentage growth where price-earning ratios will work. Buffett disparages cash flow analysis. Value, however, is nothing but the present value of cash flows. Part I discusses stock options. Part II discusses pooling accounting versus purchase accounting for the acquisition of another company and part III discusses "owner earnings," all with Buffett's comments to Berkshire-Hathaway shareholders as a departure point.

…

II. Purchase Method vs. Pooling

A. Buffett's Argument for Pooling

Spinning Against Investors. Buffett himself sometimes argues for a decidedly pro-management spin to his accounting. He is a manager being graded by the accounting, as well as an investor in other companies. He argues to the Berkshire Hathaway shareholders that he should be able to avoid a step up in the book value of an acquired company when Berkshire purchased the company for more than book value. This is pure spin, in my opinion, without any merit in economics or sound accounting. Berkshire Hathaway's books should reflect its own costs, on the merits, and not some costs borrowed from the books of its target. Buffett is thus no purist, but is perfectly willing to get the accounting wrong, when it is in his interest to do so. Still, as an investor, Buffett has a decided interest in books that convey accurate information, so that his position undercutting the accuracy of the books undercuts his long interest on the investor side.

Protecting the Prize. In 1986 Berkshire Hathaway bought Scott Fetzer, the publisher of the World Book Encyclopedia. Berkshire paid cash of $315 million, which was $143 million more than the net worth of the company as reported on the pre-acquisition books of Scott Fetzer. The extra $143 million cost was allocated among various assets, including inventory and depreciable assets, such that $12 million of the extra cost was amortized to reduce 1986 income. Scott Fetzer would have looked like better in its 1986 income statement, Buffett complains, without the extra $12 million charge.[2] The extra book value increased the depreciation and inventory expenses and made the acquired company look like less of glittering prize.

Higher Value than Book. It is common for an attractive company to have a real or fair market value in excess of its book value. Accountants have lost almost all of their loyalty to the balance sheet. As a matter of high theory, a balance sheet should be like a wealth statement or a bank account balance, stating a base upon which interest at current rates can be expected to be earned during the coming year. But accountants under current generally accepted accounting practices ("GAAP") have given up on that ideal and tend to create balance sheets that describe nothing about the outside world. A balance sheet is often just the back warehouse storing the residue of costs that have not yet been written off, but are waiting.

Paid more in Scott Fetzer. Substantially all ($10.5 million of $12 million) of the extra expenses that Buffett complained about in the Scott Fetzer acquisition were attributable to Berkshire Hathaway paying more for inventory and depreciable property than the book value Scott Fetzer recorded for those assets. It is not surprising to find that Berkshire paid more for depreciable assets than reflected on Scott Fetzer accounts, even buying the company as a whole. Assets inflate and depreciation commonly drops the asset account below their real value. Scott Fetzer's balance sheet was especially inaccurate, moreover, because Scott Fetzer,reported its inventory under the LIFO convention. LIFO, meaning Last-in, First-Out, is a cost convention for inventory that treats the most recent prices as the cost of sold units (which reduce current income) and treats the oldest prices as the costs of the units retained (which show up as the assets on the balance sheet). After any time goes by, the LIFO convention means the prices reflected in the retained inventory or asset account on the balance sheet are fossilized costs. Assume, without any verification from me, that when the Scott Fetzer inventory accounts were set up, the World Book Encyclopedia cost the publisher $52 for all 26 volumes. Berkshire Hathaway paid more than that per set, even at its best bargain, as a part of the overall $315 million it paid for Scott Fetzer as a whole.

---

[2] *Warren Buffett Essays* 105-108

Assume, again without any verification from me, that the sets in inventory cost Berkshire Hathaway $1400 per set in the acquisition of Scott Fetzer. The inventory asset account would be twenty times higher after the Berkshire acquisition than before. Any of that $1400 price that showed as a cost of encyclopedias sold surely would hurt Berkshire Hathaway's reported earnings. But that is because Berkshire did not get to buy the encyclopedias for $52 a set. Buffett just wishes they had.[3]

Super Profit Dissolves. More generally, arm's length bargaining always tends to take away supra-normal investment returns. Assume, for instance, a company started in Founder's garage with $100,000 capital. Founder's company then grows to the point that it generates $100,000 cash dividends per year. Under the historical cost convention used by current GAAP, the founder has a return on capital of 100% annually, which is a quite extraordinary investment turn. A purchase comes along and determines that a 10% discount rate is appropriate for the risks, and so pays Founder $l million for the business. The purchaser does not have 100% return. The $100,000 net income the business generates is just a normal 10% return on the $l million investment. Founder's initial $100,000 investment (like Scott Fetzer's initial $52 World Books) does not matter to the acquirer.

---

[3] The smaller items are also no surprise. $24 million of the purchase price was allocated to price in excess of fair value of specific assets -- i.e. goodwill or going concern value. At least one-fortieth of the goodwill is charged to earnings each year, which mean Berkshire lost another half million of earnings that Scott Fetzer got to report. The surprise aspect here is how small this was. Information companies usually have all their value in good will. A very profitable publisher, for instance, might have no accounting assets -- all rented desks and office space and intangibles too gossamer-like ever to be reflected on the books. An outside buyer would pay millions because the people who show up at work, more or less on timish, have the capacity of generating millions in revenues, even though the people are not an asset hard enough to be reflected on GAAP books. As these things go, Scott Fetzer was low on intangibles.

It is also not surprising that Berkshire Hathaway decreased the "deferred tax" liability on Scott Fetzer's books. Deferred taxes are wildly overstated, so that a company can announce that it is paying its taxes as a good citizen at the current statutory rate. As a matter of economics, the real or effective tax rates that corporations pay hoover around zero and the statement of the tax expense at the statutory tax rate is just nonsense. The real detriment of those Scott Fetzer deferred taxes apparently was under a quarter of their stated book value and that probably overstates the detriment as well.

Pooling Method. The ability of an acquirer to step into the shoes of the target and use its old asset accounts to compute cost is called the "pooling method of accounting." Back before 1970, the pooling method was a wide open way for high-price-earnings "conglomerates" to purchase earnings of some target corporation without reflecting their costs. If the closing could be effected before the books were closed, then the annual earnings of the target would be added to the earnings of the conglomerate, but the asset accounts and depreciation expenses would not be increased.[4]. In 1970 the Accounting Principles Board, then the standard setter for GAAP accounting, proposed to limit poolings to mergers to corporations of roughly equal size. The reaction by management was immediate, intense and unfavorable. Still, even in the face of the oppostion, the final standards for poolings cut back on the availability of pooling although not as far as the porposal. Under the 1970 recodification, pooling is limited to cases in which the target shareholders gets nothing but voting stock of the acquirer, so that the target shareholders achieve a continuing participation in the business they gave up. The rationale for the pooling rule that survives is that the acquisition is a commercial marriage by which two groups of shareholder decide to intertwine their lives: "[A pooling is] in substance a transaction between the combining stockholder groups and does not involve the corporate entities. The transaction therefore neither acquires nor justifies establishing new basis of accountability for the assets of the combined corporation."[5]

No marriage in Scott Fetzer. The remaining pooling method does not cover Berkshire Hathaway's acquisition of Scott Fetzer. Berkshire Hathaway did not give voting stock to Scott Fetzer, symbolizing a commercial marriage between two shareholder groups. Berkshire bought them. Pooling is appropriately not available.

Purchase Method Reflects Acquirer's Costs. Pooling should have been abolished in 1970, in full, and undoubtedly would have been if the APB had been more investor oriented

---

[4] See, e.g., *Accounting Questions in Corporate Acquisitions,* SECURITY MARKET AGENCIES, HEARINGS BEFORE THE SUBCOMM. ON COMMERCE & FINANCE, H. INTERSTATE & FOREIGN COMMERCE COMM., 91st Cong., 1st Sess. 18 (Feb. 25, 1969)(Statement of Hamer Budge, Commissioner of Securities and Exchange Commission): Abraham Briloff, *Accounting Practices and the Merger Movement*, 45 NOTRE DAME LAWYER 604 (1970).

[5] Accounting Principles Board Opinion No. 16, Business Combination, ¶16 (1970)

or not had so much management pressure.[6] Investors need to know the performance of a firm judging it from how it is using costs, setting costs at current value and according to its own costs.. An acquisition of the company is properly an event upon which the asset accounts are adjusted to current value. It is the costs to Berkshire and not to Scott Fetzer that count for Bershire shareholders. The costs to Berkshire Hathaway are set by the transaction. As the Accounting Board put it,

> "[A] business combination is a significant economic event which results from bargaining between independent parties. Each party bargains on the basis of his assessment of the current status and future prospects of each constituent as a separate enterprise and as a contributor to the proposed combined enterprise. The agreed terms of combination recognize primarily the bargained value... [7]

An acquisition is a purchase in which Berkshire Hathaway buys assets or businesses for a known, bargained price. Berkshire Hathaway's costs are what count.

<u>Bring Costs to Current</u>. Accounting in favor of investors would also bring book value of assets as close to current value as possible, whenever possible. "The reported cost of holding an asset -- its depreciation [and cost of goods sold] will best approximate the real cost of holding that asset when its net book value approximates its current market value."[8]

<u>Purchase is More Accruate on Fetzer</u> When Buffett made a side-by-side comparison of how Scott Fetzer would have reported income and how Berkshire reported income from the business after the acquisition, he implied that Berkshire should have been able to follow the pre-acquisition accounting. But in the comparison, it is the pre-acquisition accounting which is less informative to investors. Scott Fetzer got to use the historical cost convention and LIFO and that meant that it sometimes used ancient costs in reporting current profits. A company that dips into its lower tiers of LIFO inventory, for example, will look quite profitable for

---

[6] For a description of an APB folding, see James F. Fotenas, *Accounting for Business Combinations: A Critique of APB Opinion Number 16*, 23 STAN. L. REV. 330, 347 (1971)

[7] APB No. 16, *supra* note 8, ¶19.

[8] James F. Fotenas, *supra* note 9, at 23 Stan L. REV. at 340

GAAP. If Scott Fetzer got to report the cost of any of its encyclopedia sets at $52, then it is no wonder that it reported a profit. Accounting in favor of investors would tell investors how the encyclopedia business is doing under current costs.

Not an Individual Pathology. An intense management drive for pooling, although it is an inferior method, is not confined to Berkshire Hathaway. Professors Lys and Vincent, for instance, report that when ATT took over NCR by hostile bid for shares, they paid an extra 1/2 billion dollars for NCR to be allowed to use pooling rather purchase accounting for the acquisition.[9] The 1970 pooling rules prohibit customizing a target in preparation for a merger, for instance, and NCR had just issued some stock to management that had to be redeemed back. The extra 1/2 billion dollars was real money, but prize they gained -- pooling accounting -- had no effect on cash flow or economics. ATT, however, was willing to spend an extra 1/2 bill just to spin control the value of its stock on investors.

Forget the Efficient Market. Management in general does not not believe that the market is smart enough to see through its creative accounting. Accounting thus influences management behavior. Standards count. When standards induce management to take uneconomic activities, the standards hurt the country. I fought in a war in which standards affected behavior. The accounting measure of success in the Vietnam was "body count." Whatever was the more ethereal goals of the Vietnam war, on the ground in the field, the operational goal was a unit called "body count." Only later was the standard refined so that to "confirmed VC dead." The quality of accounting standards matters.

Cheap Shot follows. Warrent Buffett is, of course, quite articulate about misaccounting. Management he told us, as to stock options, that management should not sweep costs under the-rug. Competitiveness, he tells us, is "achieved by reducing costs, not ignoring them."[10] The dog's fifth leg, finally, remains a tail, no matter what it is called.

B. Non amortization of Good Will.

---

[9] Thomas Lys and Linda Vincent, *An Analysis of Value Destruction in AT&T's Acquisition of NCR*, 39 J. OF FIN. ECON. 353 (1995).

[10] Employee Stock Options. at 15, 16.

Goodwill is forever. A better argument is that goodwill should not have to be amortized. In his must recent discussion in "Berkshire Hathaway Inc.: An Owner's Manual," (1996), Buffett argues that goodwill in his acquisitions does not decline and should not be amortized. Goodwill is the extra value paid for a firm that can not be attributed to any specific assets. A going concern almost always has goodwill because it is worth more than the sum of its specific assets. A business company is living organism, able to recruit and train people, buy materials, add value, sell and distribute the product. An information company that rents its office might have only trivial assets that are tangible enough to be listed as accounting assets and yet be able to generate millions in income. An acquirer would be willing to pay for those millions of dollars the firm generates, but all of the value of the firm is in the goodwill. In the next century as we move increasing to wealth in the form of information, many companies will have nothing but goodwill. When Berkshire Hathaway acquired the half of GEICO it had not previously owned, in any event, it acquired goodwill of $1.6 billion, not attributable to any specific assets.[11] Current GAAP requires that goodwill must be written off against earnings over a period of 40 years.[12]

Like Stock. Buffett argues that the goodwill of the companies he manages will not decline and will not be lost and that he should not be charged, one-fortieth (2-1/5%) per year against earnings. I find that argument to be quite persuasive. If Berkshire had acquired GEICO stock of $1.6 billion, we would recognized that the stock is an investment likely to remain in tact. Stock will fluctuate in value, but it will not inevitably decline in value so that the asset or investment does not need to be amortized. Purchase of stock and purchase of business are just alternative forms to accomplish the same acquisition, so that there is no good reason for the disparity.

Amortization not on the Merits. Amortization of good will over a period of not more than 40 years was proposed by the Staff of the SEC in order to curb accounting incentives for corporate takeovers.[13] The

---

[11] Berkshire Hathaway Inc: An Owner's Manual 13 (1996). See also *Essays of Warren Buffett* 113 (1983 Appendix)(arguing that See's Candy goodwill was not a true economic cost because the goodwill did not decline)

[12] AICPA Accounting Principles Board, Opinion No. 17, Intangible Assets ¶9 (1970).

[13] Hamer Budge (SEC Commissioner), *Accounting Questions in Corporate Acquisitions, Security Market Agencies, Hearings before the Subcomm. on Commerce & Finance, H. Interstate & Foreign Commerce Comm.,* 91st Cong., 1st Sess. at 18 (Feb. 25, 1969) APB Opinion No. 17 was

SEC was worried that mandatory write off of intangibles was necessary to control management and prevent management from ignoring economic losses.[14] If amortization were discretionary, then management would not always write down the goodwill when the value of the company in fact declined below its acquisition price. Forty-year amortization was thus motivated to control management and penalize takeovers. Forty-year amortization is not an accurate description when the acquired company is improving in overall worth, in excess of specific assets. The balance sheet asset for the acquired firm should be describing the investment or bank account value of the asset.

Wrong Remedy. Nonetheless Buffett chosen remedy does not fit his argument. The argument is that goodwill should not be depreciated because it does not decline in value. The remedy Buffett chooses, however, is to "present our operating earnings in a way that allows you to ignore all purchase-accounting adjustments."[15] The right remedy is just to present earnings in a way that the charge for 2-1/2% of goodwill stands out. The asset value of all the other assets needs to stepped up, however, in purchase-accounting adjustments, and assets that are depreciating or are sold need to have the higher acquisition costs as their new accounting asset. For Scott Fetzer, Buffett's argument about goodwill would have affected a charge to earnings of one-half million dollars and his remedy would have gotten rid of a charge of $10.5 million. I worry that Buffett's argument is a silk screen for a non meritorious pro-management remedy, presented so well that investors will be taken in.

Do it for Tax. The bigger point that goodwill should not be amortized in an accounting that describes the company's investment is a good point. I have spent a fair amount of time arguing that goodwill should not

---

proposed and considered in tandem with APB Opinion No. 16, which severely limited use of the advantageous "pooling" method for accounting for corporate acquisitions. The SEC Staff in Opinion No. 17 wanted a 33 1/3 life for amortization, the AICPA on behalf of clients wanted a 50 life and the 40 year life chosen in Opinion No. 17 is a arbitrary compromise, about midway between the two.

[14] See, e.g., Rapport, SEC ACCOUNTING PRACTICE AND PROCEDURE 3-35, 7-10 (3d ed. 1972)(SEC had for a number of years before Opinion No. 17 taken the informal position that intangibles had to be written off, because intangible assets sometimes masked deteriorating profits)

[15] Berkshire Hathaway Inc: An Owner's Manual at 13 (1996)

be amortized for tax purposes.[16] Notwithstanding my arguments, Congress adopted 15 year amortization of goodwill.[17] The tax write-offs misdescribe the economics and reduce the real tax rate on corporate takeover investments to a point materially below the statutory tax rate applied to competing investments. Warren Buffett should have made his fine argument that goodwill does not decline to the tax writing committee in 1993. Perhaps two Quixotes would have done some good.

---

[16] See, e.g., Calvin Johnson, The Mass Asset Rule Reflects Income and Amortization Does Not, 56 TAX NOTES 629 (1992). See also all by Calvin Johnson, Letters to the Editor, Component Depreciation for the Purchase of Businesses, 58 TAX NOTES 984 (February 15, 1993); Once More Into the Mass Assets, 58 TAX NOTES 369 (January 18, 1993); The Mass Asset Rule is Not the Blob that Ate Los Angeles, 57 TAX NOTES 1602 (December 14, 1992); Sowing Mass Confusion, 57 TAX NOTES 1087 (November 16, 1992); The Argument over *Newark Morning Ledger*, 57 TAX NOTES 1090 (November 16, 1992); *Newark Morning Ledger:* Intangibles are Not Amortizable, 57 TAX NOTES 691 (November 2, 1992).

[17] IRC §197.