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ACCOUNTING IN FAVOR OF INVESTORS

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Introduction: Framework

Servant of the Market. Financial accounting is the servant of the efficient market. The function of the audited financial statement is to help outside investors allocate capital to the best investments with the lowest possible transaction costs. To run an efficient market, investors need 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 stock price indicators depart from real values, capital is misallocated and misused.

Grading Standards. To have a fast public market, standards of grading must be enforced. To draw an analogy, a commodities exchange in soybean futures cannot be run unless the soybeans are graded to keep cockleburs out of the soybean bushels. Spot spraying for cockleburs may be expensive, but grading has to be quick and standardized. Commodities must be fungible and traders must be able to assume the grades quickly. Fine judgments about the gradations of cockleburs in any bushel are difficult to make when trading in minimum units of 5000 bushels.

Grading of Stock. Similarly, a national stock market cannot be run unless someone is maintaining the standards by which the stock is graded. Without accounting standards, the stock market would resemble the real estate market, with lots of inspections, 6% broker's commissions on both sides, and two-year waiting periods to find a buyer.

Lower the Cost of Capital. The benefits that management gets from accounting standards comes only indirectly by way of service to investors. The major benefit to managers of increased disclosure in the United States is higher stock prices and hence a lower cost of capital. Investors who do not have reliable information about firms must underbid for their stock because the risk that the stock is a "lemon" must be included in their calculations.[1] Countries that

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[1] George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* 84 Q.J. Econ. 488 (1970) is the seminal piece for the argument. For an appli-

do not provide investors with significant information do not have well developed public capital markets. Since diversified investors are not protected, companies are not able to raise capital from them.[2] Consequently, in countries without a broad stock market, companies need to acquire their capital from large, institutional investors who seek to dominate the company. Management can get firm-specific benefits by successfully fooling the market through manipulated earnings or with overly positive or optimistic reports; however, fooling the market hurts not only the specific investors who are fooled, but also all other users of capital by driving up the cost of capital. Managers as a whole get significant benefits from high quality standards, but only insofar as such standards succeed in serving the diversified public investor.

Sole Client Is the Market. The market is the only client of public financial accounting. Accountants' loyalty to the market must trump their loyalty to the firm's management. Accountant loyalty to the market must be brutally enforced. Management is too willing to cheat the market by manipulating earnings to give a false impression.[3] Accountants owe no duty to the firm: In the game of auditing, the accountants are the cops and managers are the robbers. Public accountants earn their pay only when their accounting reports improve investor allocation of capital. Only by serving investors do accountants serve the management that selects and pays them.

Other Kinds of Accounting. Financial accounting is different from other forms of accounting. Accounting provided for management's own use is called "cost accounting,"[4] division reports, or anything that management wants to call it, but not "financial accounting." Management is in control and it can ask for numbers about its own businesses created under any theory that it wants. Accounting provided for creditors is called a "loan application,"

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cation of the argument to accounting, see P.K. Chancey & C.M. Lewis, *Earnings Management and Economic Valuation Under Asymmetric Information*, 1 J. CORP. FIN. 319 (1995).

[2] *See* RAFAEL LA PORTA ET AL., LAW AND FINANCE (National Bureau of Econ. Research Working Paper No. 5661, 1996) (surveying the law of 49 developed countries and finding that diversified capital markets are not important in countries that fail to protect shareholder rights).

[3] *See, e.g.*, William J. Bruns, Jr. & Kenneth A. Merchant, *The Dangerous Morality of Managing Earnings,* MGMT. ACCT., Aug. 1990, at 22 (concluding that 80% of management surveyed does not consider manipulating earnings to be fraudulent or serious when the change smooths income spikes or is accomplished by changes in operations).

[4] *See, e.g*, CHARLES T. HORNGREN, COST ACCOUNTING: A MANAGERIAL EMPHASIS (7th ed. 1991).

"credit report," "indenture accounting,"[5] or anything the creditor wants to call it, but not "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. Management tries to spin the market value of its stock and to use financial reports as advertising to pull in investors. Management, unfortunately, wins too many of these battles, more than is good for allocation of capital. There has, for instance, been a revolution in financial information and analysis over the last twenty years, but the financial revolution has not yet affected the accounting information that management furnishes to its owners and investors.[6] The Financial Accounting Standards Board ("FASB") is still struggling with the "net present value" concept[7] as if it were a difficult issue, and is struggling hard to avoid the unfathomable difficulties of the concept of "market" as in "fair market value" or "mark to market" even for assets with a readily ascertainable value.[8] Management, above all else, should be disclosing information about the diversifiable and nondiversifiable risk the company is facing,[9] but

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5 See, for example, American Bar Foundation, Commentaries on Indentures (1971), on indenture reporting.

6 *See* Dennis R. Beresford & John A. Hepp, *Financial Statement Disclosures: Too Many or Too Few?*, FASB Status Rep. No. 264, May 25, 1995, at 7 (arguing that while there has been a geometric increase in recent years in financial information and analysis available to help management decisions, the same logic has not been extended to outside investors and creditors).

7 For examples and criticism of GAAP's slowness in adjusting to net present value concepts, see, for example, Calvin H. Johnson, *The Illegitimate "Earned" Requirement in Tax and Nontax Accounting*, 50 Tax L. Rev. 373, 379-82 (1995).

8 For recent calls to abandon "historic cost" asset accounts in favor of current value asset accounts in various circumstances, see, for example, Mary E. Barth et al., *Value-Relevance of Banks' Fair Value Disclosures under SFAS No. 107,* 71 Acct. Rev. 513 (1996) (providing evidence that banks' stock prices are significantly explained by current fair market value of security assets; historical cost provides no added explanation); Robert K. Elliot & Peter D. Jacobson, *U.S. Accounting: A National Emergency,* J. Acct., Nov. 1991, at 54 (proposing that historic-cost-based financial accounting is broken and needs to be fixed); James J. Leisenrig et al., *Toward a Set of Principles for Financial Instruments*, FASB Status Rep. No. 267, Aug. 21, 1995, at 4, 5 (arguing that financial instrument assets need to be measured at current fair market value); David Solomons, *Criteria for Choosing an Accounting Model*, Acct. Horizons, Mar. 1995, at 42 (arguing that historical cost fails to satisfy the basic criteria for an accounting system). *Cf.* Steve Lilien & Martin Mellman, *Time for Realism in Accounting for Employers' Pension Plans*, CPA J., June 1994, at 54, 58 (noting that changes in market values of pension plan assets are real).

9 *See* Henry T.C. Hu, *Risk, Time and Fiduciary Principles in Corporate Investment*, 38 UCLA L. Rev. 277, 299-300 (1990).

standard accounting instead "smooths" out real volatility and risk when reporting firm income. In smoothing income, standard accounting badly degrades the quality of the available information as it gives the information to investors.[10] FASB standards use old-fashioned financial concepts that make life much easier for management and auditors and much harder for outside investors. What is needed in financial accounting is data that serves real investors on real investment decisions. What is needed is accounting that is in favor of investors, rather than in favor of management.

Tighter Capture? Arguably the current FASB may never be able to create accounting standards that serve investors' needs. Management influence is simply too strong. In recent years, the FASB has made a number of specific decisions, which may solve management problems but which do not help investors to allocate capital.[11] The Financial Executives Institute ("FEI") has also called for tighter management control over the FASB.[12] Some

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10 *See, e.g.*, 2 JAMES C. BONBRIGHT, THE VALUATION OF PROPERTY 903-04 (1937) (asserting that GAAP artificially converts what is actually a highly irregular flow of cash into a standard flow called "net income."); Susan Perry & Robert Grinaker, *Earnings Expectations and the Discretionary Research and Development Spending*, ACCT. HORIZONS, Dec. 1994, at 43, 49 (finding that managers vary R&D expenditures to smooth earnings); Lawrence Revsine, *The Selective Financial Misrepresentation Hypothesis,* ACCT. HORIZONS, Dec. 1991, at 16, 18 (arguing that historic cost allows management to smooth earnings by selling appreciated assets so as to give the false appearance of lower volatility and default risk); Brett Trueman & Sheridan Titman, *An Explanation for Accounting Income Smoothing*, 26 J. ACCT. RES. 127 (Supp. 1988) (noting that management has an incentive to smooth reported income to lower the investor's perception of volatility of the company's underlying economic income). *Cf.* David Hawkins, *Daimler-Benz: A U.S. GAAP Based Stock*, *reprinted in* READINGS & NOTES ON FINANCIAL ACCOUNTING 596 (Stephen A. Zeff & Bala G. Dharan eds., 5th ed. 1997) (explaining that German GAAP's attempt to determine sustainable earnings allows management to understate volatility and hide earnings problems).

11 *See, e.g.*, ACCOUNTING FOR CERTAIN INVESTMENTS IN DEBT AND EQUITY SECURITIES, Statement of Financial Accounting Standards No. 115, ¶ 1 (Financial Accounting Standards Bd. 1993) (stating that management may avoid fair value reporting for debt securities if it has the positive intent and the ability to hold securities to maturity); ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN, Statement of Financial Accounting Standards No. 114, ¶ 51 (Financial Accounting Standards Bd. 1993) (stating that management's loan impairment measurement need not reflect changes in generally available interest rates); ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123, ¶ 26 (Financial Accounting Standards Bd. 1995) (proposing that compensation paid with stock may be reported as without cost if paid pursuant to an option that had no bargain when the stock amount and option price were set). [hereinafter FAS 123] *See also* Paul B.W. Miller, *The Conceptual Framework as Reformation and Counterreformation*, ACCT. HORIZONS, June 1990, at 23, 25 (giving AICPA the authority to set standards resulted in many GAAP standards settled on the basis of auditing concerns instead of decision usefulness to outsiders).

12 *See, e.g.*, Lee Berton, *Business Group Wants Smaller FASB, More Influence on Rule-setting*, WALL ST. J., Feb. 2, 1996, at B12 (reporting a campaign by the FEI to shrink

would go further and disband the FASB and the Securities and Exchange Commission ("SEC") and rely upon consensual contracts between the investor and the firm to provide information to investors.[13]

Public Good. "Deregulating" accounting will not improve the efficiency of the market, the quality of information, or the allocation of capital. Leaving accounting entirely under management control will not improve the allocation of capital. Accounting information is a public good: The benefits of information—e.g., minimization of waste in the allocation of capital—cannot be confined to those who pay for it; thus, it follows that it will be impossible to charge a price equal to the social value provided by accounting information.[14]

Unorganizable Bargains. Moreover, contractual bargaining is not mechanically feasible, especially when there are millions of investors. Contractual bargaining can provide a great deal of information when capital is provided by a single institutional investor who will dominate the firm, but bargaining cannot reach and enforce viable reporting standards for millions of diverse potential investors. The SEC stands as their proxy. Without mandated disclosure, well organized insiders, with their control of information,

FASB's staff and increase business influence on the rule-setting process). *But see* Harriot Hanlon, *Financial Accounting Foundation to Change Composition for Its Board,* 72 TAX NOTES 343 (1996) (reporting reduction in FEI appointed trustees and increase in public interest trustees on FASB's governing board); Roger Lowenstein, *Intrinsic Value: Can FASB Be Considered Antibusiness?*, WALL ST. J., Mar. 20, 1995, at C1 (opposing FEI's call for the FASB to stop being an accounting policeman); Rachel Witmer & Steve Burkholder, *SEC's Chief Accountant Stresses Importance of an Independent FASB*, Daily Tax Rep. (BNA) No. 32, at G-1 (Feb. 16, 1996) (reporting opposition by SEC's Chairman and Chief Accountant to changes that would undermine the perceived independence of FASB).

13 For arguments against mandatory disclosure, see, for example, Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law,* 89 COLUM. L. REV. 1549, 1557 (1989) (arguing that investors get protection from the accuracy of the market even though they do no research themselves); George J. Stigler, *Public Regulation of the Securities Markets,* 37 J. BUS. 117 (1964) (arguing that return rates on stock after SEC regulation are no higher than return rates before SEC regulation in the 1920s although they are less variable). For arguments in favor of mandatory disclosure at least in some circumstances, see, for example, Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 952-53 (1991) (arguing for disclosure as a default legal rule); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722 (1984) (arguing that market fails to disclose bad news without mandated disclosure); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984) (arguing that mandatory disclosure prevents duplicative research by different investors and that a special case may be made for disclosure of industry-wide data and low-cost disclosures).

14 *See* QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2, ¶ 135 (Financial Accounting Standards Bd. 1995).

would eat disorganized investors for lunch. Insiders will simply use their favorable position to extract increased rents from the market.

Disclosing Anti-Management News. Management will not voluntarily disclose bad news—even news that is merely less than superlative—because it is not in their interests to do so.[15] The function of SEC and FASB accounting regulation is to force management to disclose information that it does not want to disclose and to force auditors to audit issues that they would not voluntarily audit.[16] Improved accounting may well hurt specific management's short-term interests in order to serve the greater needs of the efficient market. The grand function of accounting should be understood as taking away management's exploitation of insider position and shifting the benefit from management to investors to allow the proper allocation of capital.[17]

Buffett's Role. Warren Buffett has sometimes been an ally of investors in the accounting wars. Buffett has been articulate in arguing that compensatory stock options are properly included in expense. But Buffett is also a manager of Berkshire Hathaway and his interests on the management side make him a wavering ally of investors. He is often tempted over to the dark side and tries to accomplish some pro-management spin. Buffett, for instance, has argued that Berkshire Hathaway shareholders should rely on a schedule presented as an alternative to GAAP, under which its acquisitions were reported under the pooling method of accounting. That position harks back to the 1970 accounting battles and reruns them to let the management side win. Finally, Buffett is not a very good theorist of accounting. He offers a measure of value called "owner earnings" that is not a workable tool for ascertaining stock value either in theory or in feasibility. He also inappropriately disparages the valuation of stock by discounting the present value of cash flows, which is the only sound theoretical basis for valuation.

Contents. With Buffett's comments to Berkshire shareholders as a departure point, this Article argues that financial accounting theory and practice must be based on serving investors and market efficiency. In that context, Part I of this Article argues that stock options should be treated as compensation cost. Part II discusses pooling accounting versus purchase accounting for the acquisition

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15 *See* Coffee, *supra* note 13, at 722.

16 *See* Miller, *supra* note 11, at 31.

17 *See, e.g.*, William H. Beaver, *What Should Be the FASB's Objectives?*, J. ACCT., Aug. 1973, at 49, 56 ("The role of accounting data is to prevent superior returns accruing from inside information . . . .").

of another company and argues that the pooling method is misleading. Part III discusses and evaluates the use of owner earnings to measure net present value. This Article concludes that Buffett's accounting theory and practice reveal a conflict between his dual role as investor and manager that sometimes disserves investors.

I. Stock Options

Shaman Pharmaceuticals. In October 1993, Lisa Conte testified before a hearing of the Senate Subcommittee on Securities that was organized to prevent the FASB from issuing standards that would treat stock options as a compensation expense.[18] Ms. Conte testified that as President of Shaman Pharmaceuticals, she would go into the rain forest and seek out the native shamans. She would ask the shaman: "What plants have your people and your tradition found to cure injury and sickness?" The shaman would offer her the plants of his people and she would take those plants back to her laboratory and isolate the ingredients with pharmaceutical values. She would make those ingredients available to the world to cure disease, using the traditional wisdom of the shamans for the benefit of all. And she explained, none of this would be possible without stock options.

Lisa Conte's testimony was brilliant political theater. She is a user of traditional wisdom in a world of cybercrats, a woman in a mostly man's world, and an environmentalist among tree killers. She sowed deep confusion among the opposition.[19] Ultimately her position was victorious: The FASB did not require that stock op-

18 *See Employee Stock Options: Hearing on the Proposal by the Financial Accounting Standard Board Exposure Draft, "Accounting for Stock-Based Compensation," to Require Companies to Record a Charge to Their Earnings upon the Grant of an Employee Stock Option Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong. 53-54, 87-89 (1993) (statement and testimony of Lisa Conte, President and CEO of Shaman Pharmaceuticals, Inc.) [hereinafter *Employee Stock Options*]. The material in the text is not intended to be a literal transcription of Ms. Conte's testimony, but is a parody, slightly exaggerated to bring out the political theater of her comments.

19 Although Senator Barbara Boxer, then-Chairwoman of the Subcommittee on Securities, is generally perceived as pro-consumer (100% rating from the Consumer Federation of America in 1995) and anti-business (26% rating from the Chamber of Commerce in 1995), *see* Michael Barone & Grant Ujifsa, Almanac of American Politics 142 (1997), she nonetheless lauditorily introduced Ms. Conte, see *Employee Stock Options*, *supra* note 18, at 53, and seemed genuinely confused that Senator Carl Levin thought that stock options were a cost. *Id.* at 17 ("I do not think that anyone who is on the Lieberman bill . . . objects to showing this straight out. But we are talking about expensing as compensation. That is what FASB is trying to force companies to do."). Proponents of the Lieberman bill would not be in favor of "showing straight out" the value of stock compensation and would object to reporting stock as a cost of any kind, not just a compensation cost.

tions be treated as compensation expense in reporting earnings.[20] Nonetheless, her ultimate argument—that compensatory stock given to management is cost free to the issuing corporation and should not be reported as an expense—is meritless, even silly.

Stock Is a Proxy for Cash. For a publicly held corporation, the stock it issues is nothing but a proxy for the discounted present value of the cash flows that the corporation expects to pay eventually on the stock. Without the expectation of cash distributions, as dividends or as redemption or liquidation distributions, stock is not worth the paper on which it is printed. There is no enforceable legal obligation to pay dividends nor to redeem shares or liquidate, but the market, it seems, has ways of enforcing such distributions. The basic pro-rata rule for distributions, requiring that new shareholders share equally with historic shareholders, seems to insure that cash is ultimately paid on newly issued shares.

Expensive Cash. Stock, in fact, turns out to be a very expensive way for a corporation to distribute cash because the market enforces a discount rate to compute the present value of future distributions that is extraordinarily costly to the issuing corporation.[21] Moreover, the discount rate on stock, unlike interest paid on debt,[22] must be paid with money that cannot be deducted. Stock means nothing, in any event, other than the underlying cash.[23]

Like a Profit-Sharing Plan. Stock options, in turn, are a kind of profit-sharing. Stock options are just like profit-sharing agreements settled in cash, except that the amount paid to the executive is measured by the market price of the stock rather than by an inferior index of firm value like GAAP accounting profits. Financial accounting standards treat profit-sharing arrangements settled in cash as compensation expense accrued as the amounts owed under the arrangements increase or decrease.[24] Profit-sharing ar-

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Taking the cost of stock out of compensation seems especially focused on allowing overcompensation.

[20] *See* FAS 123, *supra* note 11, ¶ 26.

[21] *See, e.g.*, Jeremy J. Siegel & Richard H. Thaler, *Anomalies: The Equity Premium Puzzle*, J. ECON. PERSP., Winter 1997, at 191 (reviewing literature showing that the return rate on stock is 2.7 times higher than the return on long-term debt).

[22] *See* I.R.C. § 163(a) (1997) (allowing deduction of interest on debt paid by a corporation); *see also* Calvin H. Johnson, *Why Is Stock So Bloody Profitable?*, 75 TAX NOTES 1893 (1997) (arguing that tax deepens the mystery as to why stock is so expensive to the issuer).

[23] *See* Calvin H. Johnson, *Stealing the Company with Free Stock Options: The Furor over Accounting Standards*, 65 TAX NOTES 355, 356 (1994).

[24] *See* FAS 123, *supra* note 11, ¶ 25 (explaining that plans arranged to be settled in cash are compensation cost for the period according to the amount of the liability to employee

rangements settled in stock are indistinguishable. A corporation has a compensation cost when it issues stock to its executives in exchange for the option price as surely as if it had agreed to pay out the bargain amount in cash, and such cost should be reported in its income statement. If the executive's bargain from the stock option increases, the company's accrued expense also increases. If the executive's bargain decreases, the company's costs are correspondingly reduced. When the option is finally exercised, the company satisfies the accrued expense with stock as a cash equivalent.

Fooling the Market. If the market spin—treating options as cost-free—has any effect at all, then the treatment Ms. Conte was asking for distorts investment decisions. Suppose an investor has five potential choices for investment: Firm *A* creates composites, graphites, and other new materials; Firm *B* creates revolutionary computer software; Firm *C* will revolutionize the computer hard drive; Firm *D* will teach the Russians and Chinese to be great and civil trading partners; and Firm *E* is Shaman Pharmaceuticals. Ordinarily in a market, the relative value of these firms is determined by the demand for their products and the costs of meeting the demand. Assume that among the five firms only Shaman Pharmaceuticals issues stock options to any material extent so that Shaman alone pays its executives with valuable stock options without reporting them in its financial reports to investors. Such nonreporting will be advantageous to Shaman Pharmaceuticals simply because it will induce the investor to forego alternatives *A* through *D* and invest in Shaman instead. If the investor is indeed induced to invest in Shaman because of such nonreporting, the investor will take lower returns from or suffer greater risk of loss in Shaman compared to investments in other firms.

No Such Thing As a Free Lunch. From the viewpoint of the firm issuing stock options, the advantage of excluding the options from reported compensation expense looks like a free lunch. The understatement of costs induces investors from out of nowhere to buy the firm's stock. From the viewpoint of investors, however, the stock given out to others is not cost-free and investors are properly resentful of understatements of cost. Investors relying on the Shaman financial reports will have to accept lower returns or assume greater risks when they invest in Shaman and not in other, better

at the current stock price); ACCOUNTING FOR STOCK APPRECIATION RIGHTS AND OTHER VARIABLE STOCK OPTION OR AWARD PLANS, FASB Interpretation No. 28 (Financial Accounting Standards Bd. 1978) (showing illustrations and details of plans settled in cash).

opportunities. The lower returns or greater risks are real costs to investors.

Pay for It. The law, plausibly, should require firms that report stock options as cost-free to pay for investors' losses. Perhaps requiring firms to put up a bond would put a price tag on the bad accounting. Putting a price tag on the losses the investors suffer avoids the cost-free fallacy under which actors impose costs far in excess of benefits simply because they have not properly accounted for the costs. The worst decisions are usually made when costs are hidden and not even understood to be costs by the actors who are making the decisions.[25]

Accounting Demonstration. The intensity of management reactions against reporting stock options as part of compensation indicates that management expected that keeping stock options out of reported compensation would have a material effect on investors. The FASB's proposal to require the value of stock options to be reported as costs upon their issuance created a Vietnam-era style demonstration over accounting—undoubtedly the first accounting demonstration. When the FASB held a hearing in San Jose, California on its stock option proposals, Silicon Valley demonstrated in opposition.[26] Advocates of excluding stock options from cost believed that the efficient market was not smart enough to see through the accounting and that bad accounting served their self interest.[27] Even if investors on the other side are able to see through the subterfuge, accounting standards should not test the efficient market thesis or erect barriers which a smart market might or might not be able to hurdle. Accounting must serve market efficiency and investors.

Hiding Sky-High Compensation. It also seems that the Business Roundtable and the FEI succeeded in taking stock options out of compensation expense for purely selfish motives. Management compensation in the United States has grown to extraordinary levels in recent years, judged by historical standards and by com-

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25 *See, e.g.*, Harold Demetz, *Hidden Transfers: Link Gain with Pain*, WALL ST. J., May 1, 1986, at 32 (arguing that direct subsidies are more legitimate than hidden transfers because democratic procedures are more likely to err when costs are unknown).

26 *See* Stephen A. Zeff, *The U.S. Senate Votes on Accounting for Employee Stock Options*, *in* READINGS & NOTES, *supra* note 10, at 507, 512.

27 *See* Thomas Lys & Linda Vincent, *An Analysis of Value Destruction in AT&T's Acquisition of NCR*, 39 J. FIN. ECON. 353, 354 (1995) ("AT&T was willing to pay as much as $500 million extra for [its] NCR [purchase] to satisfy requirements to use the pooling-of-interests (pooling) accounting method rather than the purchase method . . . .").

parison to our trading partners.[28] These salaries are excessive rents grabbed from the market by reason of management's superior strategic position. The large corporation, to misquote Willie Sutton, "is where the money is."[29] Management would work for less. The Business Roundtable has told management compensation experts to stop supplying the business press with comparative data about management compensation if they want to maintain corporate business.[30] The Business Roundtable has also told the FASB to exclude stock option compensation from earnings.[31] The most plausible reasons for both actions were managements' self-interested avoidance of negative publicity and avoidance of the charge to earnings that might dampen the growth of their personal compensation. Stock options reported as cost-free are stealing from the company.[32]

Buffett the Hero. Buffett was a Quixotic hero of the 1993 hearings in which Ms. Conte testified. He wrote letters to the Senate Subcommittee on Securities opposing "sweep-the-costs-under-the-rug" accounting and argued that competitiveness was "achieved by reducing costs, not ignoring them."[33] In a widely cited comment, Buffett plainly observed:

> It seems to me that the realities of stock options can be summarized quite simply. If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it?

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28 *See, e.g.*, DEREK BOK, THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA 95, 297 (1993) (doubting that "mind-numbing" levels of executive pay properly allocate talent in a manner that corresponds to America's needs and goals); GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES 23-28 (1991) (observing that Japanese CEOs are paid at one-seventh the level of comparable American CEOs); Peter F. Drucker, *Is Executive Pay Excessive?*, WALL ST. J., May 23, 1977, at A20 (proposing to limit CEO pay to approximately 20 times the average worker's pay); George F. Will, *Ripping off Capitalism*, WASH. POST, Sept. 1, 1991, at C7 (arguing that "ludicrous" CEO salaries are sometimes "looting").

29 PAUL F. BOLLER, JR. & JOHN GEORGE, THEY NEVER SAID IT: A BOOK OF FALSE QUOTES, MISQUOTES, AND MISLEADING ATTRIBUTIONS 121 (1989) (noting that a newspaper reporter rather than Willie Sutton said, "I rob banks because that's where the money is.").

30 *See* ROBERT VAN RIPER, SETTING STANDARDS FOR FINANCIAL REPORTING: FASB AND THE STRUGGLE FOR CONTROL OF A CRITICAL PROCESS 152-53 (1994).

31 *See id.* at 136-37.

32 *See* Johnson, *supra* note 23, at 356; Calvin H. Johnson, *Stealing the Company with Free Stock Options: The Furor over Accounting Standards—Part II*, 65 TAX NOTES 479 (1994); *see also* Calvin H. Johnson, *Letter to the Editor, Professor Johnson Replies to FASB*, 65 TAX NOTES 1149 (1994).

33 *Employee Stock Options*, *supra* note 18, at 15-16.

> And, if expenses shouldn't go into the calculation of earnings, where in the world should they go?[34]

It is unfortunate that Buffett did not win. Still, his allusion to Abraham Lincoln is particularly apt:

> Managers thinking about accounting issues should never forget one of Abraham Lincoln's favorite riddles: "How many legs does a dog have if you call his tail a leg?" The answer: "Four, because calling a tail a leg does not make it a leg." It behooves managers to remember that Abe's right even if an auditor is willing to certify that the tail is a leg.[35]

II. Pooling Method vs. Purchase Method

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 judged by accounting as well as an investor who uses accounting to make judgments about others. 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. Buffett is thus no purist, and is perfectly willing to get the accounting wrong when it is in his managerial interest to do so. His undercutting the accuracy of the books, however, undermines his renowned interest as an investor.

Protecting the Prize. In 1986, Berkshire Hathaway bought Scott & Fetzer, Inc., the publisher of the World Book Encyclopedia. Berkshire paid $315 million in cash, which was $143 million more than the net worth of the company as reported on the preacquisition books of Scott Fetzer. The extra $143 million was allocated among various assets, including inventory and depreciable assets, so that $12 million of the extra cost was amortized to reduce 1986 income. Scott Fetzer would have looked a lot better in its 1986 income statement, Buffett complains, without the extra $12 million charge.[36] The extra book value increased the depreciation

34 *See* Lawrence A. Cunningham, Compilation, *The Essays of Warren Buffett, Lessons for Corporate America*, 19 Cardozo L. Rev. 1, 198 (1997) [hereinafter *Buffett Essays*]; Van Riper, *supra* note 30, at 154 (calling the comment widely cited); *Taking Account of Stock Options: Will FASB's Proposal Be the End of Stock-Based Compensation?*, Harv. Bus. Rev., Jan.-Feb. 1994, at 27.

35 *Buffett Essays, supra* note 34, at 198.

36 *See id.* at 180-87.

and inventory expenses and made the acquired company look like less of a 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 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 practices have abandoned that ideal and tend to create balance sheets that describe nothing about the firm. A balance sheet often is just the back warehouse storing the residue of costs that are waiting to be written off.

Paid More in Scott Fetzer. Substantially all—$10.5 million of $12 million—of the extra expenses that Buffett complained of in the Scott Fetzer acquisition were attributable to Berkshire Hathaway's 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 a higher price for depreciable assets compared to their value reflected on Scott Fetzer's accounts. Assets are subject to inflation, and GAAP depreciation commonly drops the book asset account below their real value. Scott Fetzer's balance sheet inventory accounts were especially inaccurate because Scott Fetzer reported its inventory under the "Last-in, First-out" ("LIFO") convention. LIFO is a cost convention for inventory that treats the oldest prices as the costs of the units retained and reported as assets on the balance sheet. As time passes, the LIFO convention means that the prices reflected in the retained inventory or asset account on the balance sheet are fossilized costs from the start of the firm's history. 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 the entire twenty-six-volume set. Berkshire Hathaway paid more than that per set, even at its best bargain, as part of the $315 million it paid for Scott Fetzer as a whole. 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 then 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.[37]

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 *X*'s garage with $100,000 capital. *X*'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, *X* has a return on capital of 100% annually, which is a quite extraordinary investment return. A purchaser, *Y*, comes along and determines that a 10% discount rate is appropriate for the risks, and so pays *X* $1 million for the business. *Y* does not have a 100% return. The $100,000 net income the business generates is just a normal 10% return on *Y*'s $1 million investment. *X*'s initial $100,000 investment (like Scott Fetzer's initial set of $52 World Books) does not matter to Y.

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." Before 1970, the pooling method was subject to such abuses[38] that the Accounting Principles Board ("APB"), then the standard setter for GAAP

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[37] The smaller items are also not surprising. Twenty-four million dollars of the purchase price was allocated to price in excess of fair value of specific assets—e.g., goodwill or going concern value. At least 1/40 of the goodwill is charged to earnings each year, which means that Berkshire lost another half million in earnings that Scott Fetzer got to report. The surprising aspect here is how small this was. Information companies usually have most of their value in goodwill. A very profitable publisher, for instance, might have no accounting assets—its facilities and equipment may all be rented and its intangibles may be too gossamer-like ever to be reflected on the books. An outside buyer would pay millions because the people who show up to work, more or less on time, have the capacity of generating millions in revenues, even though the people are not an asset hard enough to be reflected on GAAP books.

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 hover around zero, and the statement of the tax expense at the statutory tax rate is just nonsense. The restated detriment of those Scott Fetzer deferred taxes was less than a quarter of their stated book value and even that probably overstates the detriment.

[38] *See, e.g.*, *Security Market Agencies, Hearings Before the Subcomm. on Commerce & Finance, of the House Comm. on Interstate & Foreign Commerce*, 91st Cong. 18 (1969) (statement of Hamer H. Budge, Chairman of the SEC) [hereinafter *Security Market Agencies*]; Abraham J. Briloff, *Accounting Practices and the Merger Movement*, 45 Notre Dame Law. 604 (1970). The primary abuse was the "purchase of earnings," which is not an issue in the Berkshire Hathaway-Scott Fetzer acquisition. Purchase of earnings refers to the practice under the pooling method by which an acquirer could acquire a target immediately before the acquirer had to publish its earnings and include the prior year's earnings of the target in the acquirer's final earnings reports of earnings for the year. An acquirer with a high price-earnings ratio on its stock could find it cheaper to buy earnings with its own

accounting, proposed to limit poolings to mergers of corporations of roughly equal size. The reaction by management was "immediate, intense and unfavorable."[39] Still, even in the face of the opposition, the final standards for poolings cut back on the availability of pooling although not as far as the proposal. Under the 1970 recodification, pooling is limited to cases in which the target's shareholders get nothing but the acquirer's voting stock, thereby maintaining a continuing participation in the business they gave up. The rationale for the surviving pooling rule is that acquisitions that may be reported as poolings are a commercial marriage by which two groups of shareholders 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 requires nor justifies establishing a new basis of accountability for the assets of the combined corporation."[40]

No Marriage in Scott Fetzer. The recodified pooling method does not cover Berkshire Hathaway's acquisition of Scott Fetzer. Berkshire Hathaway did not give voting stock to Scott Fetzer's shareholders, but rather bought Scott Fetzer, hence pooling was not available. Buffett, however, presented his analysis of how Scott Fetzer would look under the pooling method with an argument that the pooling method better reflected how well he had done with the acquisition.

Purchase Method. Pooling should have been abolished in 1970, and undoubtedly would have been if the APB were more investor-oriented or less subject to management pressure.[41] Investors need to know the performance of a firm by judging its costs set at current value. Accounting in favor of investors would also equalize the book value of assets as close to their current value 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."[42]

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stock than to suffer a drop in value when it was discovered that its own internally generated earnings were not keeping up with market expectations.

39 James F. Fotenos, *Accounting for Business Combinations: A Critique of APB Opinion Number 16*, 23 STAN. L. REV. 330, 347 (1971). For a description of lobbying efforts to force the Accounting Standards Board to retreat, see *id*. at 346-48.

40 BUSINESS COMBINATIONS, Accounting Principles Board Opinion No. 16, ¶ 16 (Financial Accounting Standards Bd. 1970) [hereinafter APB Opinion No. 16].

41 *See* Fotenos, *supra* note 39, at 347.

42 *Id*. at 340.

Acquirer's Costs Count. An acquisition of the company is properly an event upon which the asset accounts are adjusted to reflect their current value. What matters for Berkshire shareholders is the costs to Berkshire and not to Scott Fetzer. The costs to Berkshire Hathaway are set by the transaction. As the APB 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 values . . . .[43]

The Scott Fetzer acquisition was a purchase in which Berkshire Hathaway bought assets for a known, bargained price. Only Berkshire Hathaway's costs are relevant for its shareholders.

Purchase Is More Accurate on Fetzer. 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 used LIFO and the historical cost convention, meaning 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 GAAP. If Scott Fetzer reported the cost of any of its encyclopedia sets at $52, then it is no surprise that it reported profits before the acquisition. Accounting in favor of investors would tell investors how the encyclopedia business is doing under current, not historic, costs.

Not an Individual Pathology. An intense management drive for the pooling method is not confined to Berkshire Hathaway. When AT&T took over NCR by a hostile bid for shares, it paid an extra $500 million to be allowed to use pooling rather than purchase accounting for the acquisition.[44] The 1970 pooling rules prohibit customizing a target in preparation for a merger and NCR had just issued some stock to management that had to be redeemed back.[45] The extra $500 million was real money spent, but the prize AT&T gained—pooling accounting—had no effect on cash flow or economics. AT&T, however, was willing to spend the

[43] APB Opinion No. 16, *supra* note 40, ¶ 19, at 434.

[44] *See* Lys & Vincent, *supra* note 27, at 354.

[45] *See id.* at 365-66.

extra dollars just to report higher accounting earnings so as to manipulate the value of its stock on investors.

Forget the Efficient Market. The evidence that the pooling method in fact fools the market is at best mixed.[46] Evidence such as the price AT&T paid for pooling indicates that management does not believe that the market is smart enough to see through its creative accounting. One can never really tell what is going on inside a company, but an unnecessary $500 million in cost is evidence that accounting standards influence management behavior. When such standards induce management to take costly action, they hurt investors.

Quoting Buffett Against Misdescriptions. Warren Buffett has often denounced deceptive accounting practices. As to stock options, he cautioned against sweeping costs under the rug because competitiveness is "achieved by reducing costs, not ignoring them."[47] To recall his anecdote, the dog's fifth leg remains a tail no matter what it is called. Using the pooling method for arm's length purchases is such a fifth leg.

Return to the Battlefield. The FASB has set up a task force to reevaluate eligibility standards for the pooling method. In the first meeting of the task force, the SEC's chief accountant criticized the existing criteria as "built on a weak conceptual underpinning" and objected to the "high [cost of] maintenance" in the amount of SEC staff time that must be spent on policing and interpreting current standards.[48] Management spokesmen warned, however, that abolishing the pooling method should not be a "foregone conclusion."[49] One pro-management task force member ominously warned that the FASB should avoid the "heavy volleys of criticism,"[50] like the

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46 *See, e.g.*, RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 555-71 (2d ed. 1995) (arguing that existing studies may be looking at price after the market price has already incorporated the amortization, or that amortization, creating an expense of only 1/40 or 2½% of the intangible, may be too small to be captured by existing studies); Hai Hong et al., *Pooling vs. Purchase: The Effects of Accounting for Mergers on Stock Prices*, 53 ACCT. REV. 31 (1978) (finding no material advantage to pooling accounting). For an argument that healthy companies might be using pooling, like applying cosmetics in public, to signal that they have nothing to hide, see Claire A. Hill, *Why Financial Appearance Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141 (1997).

47 *Employee Stock Options*, *supra* note 18, at 15-16.

48 Steve Burkholder, *FASB Task Force Weighs Business Combinations, Pooling of Interests Method*, Daily Tax Rep. (BNA) No. 24, at G-7, G-8 (Feb. 5, 1997) (quoting Michael Sutton, Chief Accountant of the SEC).

49 *Id.* at G-7 (quoting Errol Cook of E.M. Warburg, Pincus & Co., Inc., New York, whose firm has taken part in the "enormous growth" in merger activity).

50 *Id.* (quoting John Deming of KPMG Peat Marwick LLP).

criticism it received on its stock-based compensation proposal, and warned that "[t]here could be a somewhat violent reaction to an abolishing of pooling."[51] Whatever the merits, the fight over the pooling method is not over.

B. *Non-Amortization of Goodwill*

Goodwill is Forever. Buffett makes a better argument when he argues that goodwill should not have to be amortized when the value of the goodwill in his acquisitions does not decline.[52] Goodwill is the extra value paid for an acquired business that cannot be attributed to any specific balance sheet assets recognized by financial accounting. A going concern almost always has goodwill because it is worth more as a whole than the sum of its specific accounting assets. A business is a living organism able to recruit and train people, buy materials, add value, and sell and distribute product. An information company that rents its office may have only trivial assets that are tangible enough to be listed as accounting assets and yet be able to generate millions in income. An outside acquirer would be willing to pay for those millions of dollars the firm generates, but all of the value of the firm is in goodwill. In the next century, as we move increasingly toward wealth in the form of information, many companies will have no value other than goodwill.

GEICO Acquisition. When Berkshire Hathaway acquired the remaining part of GEICO it had not previously owned, it acquired goodwill of $1.6 billion not attributable to any specific assets.[53] Current GAAP requires that goodwill must be written off against earnings over a period of not more than forty years. Thus, 1/40 or 2½% of the goodwill is a profit-reducing expense each year.[54] Buffett argues that his companies' goodwill will not decline and that he should not be charged the 2½% of goodwill each year against earnings.

Like Stock. That argument is quite persuasive. If Berkshire had acquired GEICO stock of $1.6 billion, the stock would be recognized as an investment likely to remain intact. Stock will fluctuate in value, but its value will not inevitably decline so as to require

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51 *Id.*

52 *See Buffett Essays*, *supra* note 34, Part V.C.

53 *See id.* at 173-80 (arguing that See's Candies's goodwill was not a true economic cost because the goodwill did not decline).

54 *See* INTANGIBLE ASSETS, Accounting Principles Board Opinion No. 17, ¶ 9 (Financial Accounting Standards Bd. 1970) [hereinafter APB Opinion No. 17].

amortization. Purchase of stock and purchase of business assets are simply alternative forms of accomplishing the same acquisition of the business. There is no good reason for treating them differently.

Historical Origins of Amortization. Amortization of goodwill, moreover, was adopted as a rule weighed against acquisition without regard to the actuality of a decline in the acquirer's investment. The concept of amortizing goodwill for a forty-year period is the product of an SEC effort to curb accounting incentives for corporate takeovers.[55] The SEC sought mandatory write-offs of intangible assets for fear that if amortization were discretionary, then management would not write down the goodwill when the value of the company in fact declined below its acquisition price.[56] Forty-year amortization was thus motivated by the need to control management and to curb takeovers. The balance sheet asset for the acquired firm should describe the investment or bank account value of the acquired firm. Forty-year amortization of goodwill, however, is not an accurate description of the acquirer's investment in the target company when the target company improves its overall worth in excess of specific assets.

Wrong Remedy. Nonetheless, Buffett's chosen remedy does not fit his argument. In arguing that goodwill does not decline in value, Buffett's remedy is to "present our operating earnings in a way that allows you to ignore all purchase-accounting adjustments."[57] The proper remedy is to present earnings in a way that flags the charge for 2½% of goodwill or to give an alternative presentation to GAAP in which there is no charge for the goodwill. The value of all the assets needs to be stepped up, however, in purchase-accounting adjustments. Assets such as inventory equipment need to have the higher acquisition costs as the new debit for the accounting asset.

Argument vs. Remedy. The inconsistency between Buffett's argument against amortizing goodwill and the remedy denying any

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55 *See Security Market Agencies*, *supra* note 38, at 18. APB Opinion No. 17 was proposed and considered in tandem with APB Opinion No. 16, which severely limited the use of the advantageous "pooling" method for accounting for corporate acquisitions. The SEC Staff in Opinion No. 17 wanted a 33⅓-year life for amortization while the AICPA on behalf of clients wanted a 50-year life; the 40-year life chosen in APB Opinion No. 17 is an arbitrary compromise, about midway between the two.

56 *See, e.g.*, *id.*; Louis H. Rappaport, SEC Accounting Practice and Procedure ch. 3 at 35, ch. 7 at 10 (3d ed. 1972) (noting that the SEC had, for a number of years before Opinion No. 17, taken the informal position that intangible assets had to be written off because they sometimes masked deteriorating profits).

57 *Buffett Essays*, *supra* note 34, at 179.

increase in asset accounts can be striking. In the Scott Fetzer acquisition, for instance, Buffett's failure to amortize the 2½% of goodwill would have affected Berkshire's annual earnings only to the extent of $500,000, whereas the remedy of "ignoring all purchase-accounting adjustments" would have erased a charge of $10.5 million.[58] Buffett's adjustment is twenty times greater than his argument. Buffett's argument may be a smoke screen for a questionable pro-management adjustment, presented so well that investors will be misled.

Factories and Books Are Not Free. At the symposium for this Issue at the Benjamin N. Cardozo School of Law, Warren Buffett argued that Berkshire Hathaway's acquisition of Scott Fetzer was solely for the purpose of acquiring goodwill, and that the factory and inventory that it acquired was inconsequential.[59] To be consistent with his argument, the factory and inventory must have had no material value to Berkshire, and Berkshire should have been willing to sell the factory and inventory for a modest price, so long as their sale did not undercut the continuing value of the firm's good name and revenue stream. Buffett made an argument on stock options which is relevant here:

> [S]ince I'm in the mood for offers, I'll make one to any executive who is granted a restricted option . . . : On the day of issue, Berkshire will pay him or her a substantial sum for the right to any future gain he or she realizes on the option. So if you find a CEO who says his newly-issued options have little or no value, tell him to try us out.[60]

If Buffett is willing to sell on a sincere belief that the assets, other than goodwill, he acquired from Scot Fetzer have "little or no value," we may similarly be able to deal.

Do It for Tax. To reiterate, not amortizing goodwill commonly makes the accounting describe the company's investment more accurately. I have, on numerous occasions, argued that goodwill should not be amortized for tax purposes.[61] Notwithstanding my

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58 *Id.*

59 *See* Lawrence A. Cunningham, Editor, *Conversations from the Warren Buffett Symposium*, 19 CARDOZO L. REV. 719, 801-03 (1997) (arguing that, in his view, it was all goodwill, even though accounting required cost to be broken down into inventory, plant and equipment, and other assets) [hereinafter *Buffett Conversations*].

60 *Buffett Essays, supra* note 34, at 199.

61 *See, e.g.*, Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not*, 56 TAX NOTES 629 (1992). *See also* Calvin H. Johnson, *Letter to the Editor, Component Depreciation for the Purchase of Businesses*, 58 TAX NOTES 984 (1993); Calvin H. Johnson, *Letter to the Editor, Once More into the Mass Assets*, 58 TAX NOTES 369 (1993); Calvin H. Johnson, *Letter to the Editor, Sowing Mass Confusion*, 57 TAX NOTES

arguments, Congress adopted a fifteen-year amortization of goodwill.[62] The tax write-off misdescribes the economics of the acquirer's investment and reduces 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 Congress in 1993. Perhaps two Quixotes would have done some good.

III. "Owner Earnings" and Net Present Value

Accounting Theory. Buffett, for all his talent, is not a very good accounting theorist. His disparaging remarks about cash flow accounting suggest a misunderstanding of a fundamental point. He also offers an awkward alternative measure of value—what he calls owner earnings—that does not seem very helpful to investors who must make real decisions, either in theory or practice. Whatever the source of Buffett's ability to find good investments, owner earnings is not such a source. Section A below discusses the relation of discounted present value and accounting concepts. Section B discusses the owner earnings measure.

A. *Time Value of Money*

1. *Net Present Value is the Only Underlying Theory*

Discounted value of cash flows is the only principle with any theoretical backing in valuing investments, including investments in stock or investments to purchase a whole company. Accounting-based measures of value are useful and legitimate only insofar as they approximate or assist in discounted cash flow analysis. Accounting did not emerge to aid in the valuation by discounted present value,[63] but by chance or design many of the core concepts of accounting can be justified in terms of the time value of money analysis, at least, given future uncertainty.

1087 (1992); Calvin H. Johnson, *Letter to the Editor, The Argument over* Newark Morning Ledger, 57 Tax Notes 1090 (1992); Calvin H. Johnson, *Letter to the Editor, The Mass Asset Rule Is Not the Blob That Ate Los Angeles*, 57 Tax Notes 1602 (1992). Calvin H. Johnson, Newark Morning Ledger: *Intangibles are Not Amortizable*, 57 Tax Notes 691 (1992)

62 *See* I.R.C. § 197 (1997).

63 *See, e.g.*, Homer Kripke, *Can the SEC Make Disclosure Policy Meaningful?*, *reprinted in* Richard A. Posner & Kenneth Scott, Economics of Corporation Law and Securities Regulation 331 (1980) (arguing that accounting arose from English law distinctions that had nothing to do with the needs of investors).

Net Present Value. As a matter of theory, an investor invests money to receive positive cash flows in the future. The future cash flows must be discounted to a present value because of the opportunity to make an interest-like return (the given "discount rate") elsewhere. The investment is better than the alternatives if the net present value is positive, that is, if the present value of the goods or cash inflows is greater than the net present value of the cash outflows.[64]

Proxies for Net Present Value. Standard GAAP accounting makes many adjustments that cannot be reconciled with net present value analysis. Nonetheless, many of the core ideas of standard accounting can be justified in terms of the net present value of the cash flows, at least with some presumptions about what will happen in the future. GAAP makes a number of reasonable presumptions, including the following:

> (a) *Investments and Assets*. An investment does not reduce net present value, although it is a negative cash flow when made. If the purchase is rational, the cash outflow or the liability incurred by the firm to purchase the asset is offset by the net present value of the cash inflows that the asset is expected to generate in the future. Thus, although an investment is an immediate negative cash flow, it can be presumed not to be a negative net present value, at least until the results of investment are known. If the company is going to cut off its reports of future cash flows beyond the end of the accounting period—as it does in its annual accounting statements—the investment stated as an asset is a fair proxy for the discounted value of the cash flows yet to be realized.
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> (b) *Borrowing*. Borrowing cash increases positive cash flow at the time of borrowing, but borrowing presumably will not increase the net present value of the company because lenders generally insist upon a fair interest charge on the loan. The obligation to repay the loan plus the interest at current fair market rates presumptively prevents the borrowed proceeds from improving net present value of the corporation.
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> (c) *Accumulations Are a Shareholder Bank Account*. Accumulated earnings do not increase the shareholder's positive

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64 For a more thorough treatment of discounted cash flow analysis for stocks, see, for example, RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 57-108 (5th ed. 1996); JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 9-37, 49 (10th ed. 1995).

No real analysis of an investment could be done without considering the diversifiable and nondiversifiable risks entailed. But the errors of owner earnings or Buffett's disparagement of discounted present value do not implicate risk, so that for this limited purpose, risk can drop out of the discussion.

cash flow, but they presumably improve the shareholder's net worth. Only the cash inflows that the shareholder receives count in calculating the net present value of the cash flows on the stock investment. Still, the cash accumulated by the corporation can be reinvested so that cash received, but not distributed, by the corporation is like a bank account that will generate further returns for the shareholder. Whether the bank account is as good as cash in hand to the shareholder depends upon whether the corporation can earn more or less than the shareholder. Still, a rational corporation accumulates earnings only if its future returns are better than the shareholder's, so we can presume that retained earnings improve shareholder net present value at least as much as a shareholder bank account would do.

(d) *Sales Proceeds Are a Proxy for Future Cash.* The sale price for a sale of stock is a proxy for the cash flows the buyer expects to receive beyond the sale, discounted to the time of sale. Buyers are presumed to be rational. Thus, even a shareholder who expects to profit only by sale of stock depends indirectly on positive cash flows from out of the corporation.

These presumptions of accounting analysis are generally sound presumptions for the purpose of valuing stock, but they are sound only because and to the extent that they are in fact fair proxies for the underlying theory of valuation—net present value of the cash flows. When accounting is right, it is because it is possible to reconcile its figures with the best estimate of present value.

Depreciation and Net Present Value. Buffett's measure of the value of an investment, what he calls owner earnings, would replace the depreciation expense with an adjustment for average investment the firm needs to maintain its competitive position.[65] Depreciation, however, soundly fits into the computation of net present value if it measures the expiration or decline in value of a firm's investment. The purchase of an asset by a firm by presumption does not represent a decline in the net present value of the firm; the present value of the cash flows yet to come offsets the cost of the investment on net. Similarly, an asset holds its value to the extent of the net present value of the future cash flows that it will generate. An asset declines in value, however, when the future cash flows become less valuable. The original cost of the asset does expire. When depreciation is set to describe the value of the firm's investments, then the remaining asset account, after the depreciation, is a fair proxy for the present value of the remaining future cash flows. The asset account then can be substituted for the future

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65 *See Buffett Essays*, *supra* note 34, at 184-85.

cash flows to be received after the end of the reporting period, to simplify the analysis. Depreciation is not itself a negative cash flow, but in theory it is supposed to measure the fact that the original cost of the asset has now expired. In theory, depreciation just measures the decline in net present value of future cash flows.[66]

2. *Profits, Earnings, and the Perpetuity Assumption*

Standard accounting also smooths reported income by matching revenue and expense. Matching was once fully justified as a necessary step to help analyze the discounted present value of future cash flows. Matching is not justified, however, when it impedes present value analysis. The worst aspect of matching is that it is justified only under an assumption that the income figure created by matching will hold constant in perpetuity or will change only at a perpetually constant rate. Before spreadsheet programs were so readily available, the mathematics of discounting uneven cashflows were daunting. Analysts, accordingly, had to reshape any information they had about the future uneven cash flows from an investment into a figure that could be presumed to extend perpetually at the same level (or at the same level with changes at a constant percentage) in order to be able to turn whatever information they had into something that was useful for valuation.

Price-Earnings Ratio. The commonly used "price-earnings" ratio, for instance, is simply a specialized application of discounted cash flow analysis with a perpetuity assumption. The price-earnings ratio is the inverse of an interest rate: A price-earnings ratio of 10:1 is like a 10% interest rate and implies that $10 invested will give the equivalent of $1 per year return indefinitely or else will give $1 per year so long as the $10 remains invested and will be worth $10 upon sale. The price-earnings multiplier is derived from net present value under the assumption that annual earnings are like cash receipts for shareholders extending in perpetuity,[67] or,

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66 Paul A. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964), shows the theory of depreciation for tax. *See also* Alvin C. Warren, Jr., *Accelerated Capital Recovery, Debt, and Tax Arbitrage*, 38 TAX LAW. 549 (1985). See, for example, DONALD E. KIESO & JERRY J. WEYGANDT, INTERMEDIATE ACCOUNTING 528 (4th ed. 1983), for an analysis of the peculiar effects of straight-line depreciation that does not measure decline in value.

67 As a matter of mathematics, the price-earnings ratio comes from the present value of a perpetual stream of payments. The formula for the present value ("*PV*") of an annuity is:

$$(1) \quad PV = PMT * \left[\frac{1 - 1/(1 + i)^n}{i}\right]$$

more commonly, that annual earnings will extend in perpetuity with annual changes at the same constant percentage of the prior year's earnings.[68]

GAAP Matching. Current financial accounting developed to provide a figure that might plausibly fit into a perpetuity presumption. Since the 1940s the organizing principle of financial account-

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with payments of "*PMT*", paid in equal amounts over number of periods "*n*", given interest or discount rate "*i*". When the number of years "*n*" is infinite, the term "$1/(1+i)^n$" becomes infinitesimally small and drops out of the present value formula (when "*n*" is large, the term "$1/(1+i)^n$" almost drops out) leaving:

(2) $PV = PMT * 1/i$

The price-earnings ratio assumes that earnings are as good as payments and that the proper price is *PV*. Dividing both sides of equation *(2)* by *PMT* and then substituting *Price* for *PV* and *Earnings* for *PMT* yields the basic price-earnings ratio:

(3) $Price/Earnings = 1/i$

A 10% interest rate is the same as a 10:1 price-earnings ratio, a 12.5% interest rate is the same as an 8:1 price-earnings ratio, and a 20% interest rate is the same as a 5:1 price-earnings ratio. For a derivation of the price-earnings ratio from a perpetual stream of earnings, see BREALEY & MYERS, *supra* note 64, at 38-40, 67-73.

68 Usually the price-earnings ratio of traded stock will also assume growth of earnings by some constant percentage each year. If we can assume, for example, a discount rate of 10% and that the $2 per share payments will increase by 8% a year ("*g*" for growth rate), then the present value of the stock will be:

(1) $PV = PMT * 1/(i-g)$

or here 1/(10%-8%) or 1/(2%) or a price-earnings ratio of 50:1.

Equation *(1)* (present value or price-earnings ratio with growth) is derived by series analysis from the basic formula that the present value of any payment is just $PMT/(1+i)^n$. Assume an infinite series that grows by "*g*" per year. The present value of a payment two years away is $[PMT * (1+g)]^2 / (1+i)^2$. The present value of an infinite series of payments is:

(2) $NPV = PMT * (1+g)/(1+i) + PMT * (1+g)^2/(1+i)^2 + \ldots + PMT * (1+g)^n/(1+i)^n$

The trick of series analysis is to find a multiplier term ("*M*") that will create two parallel series of terms that will make the unstated terms, represented by "..." in equation *(2)* drop out. One can multiply equation *(2)* by *M/M*, that is by 1, without changing the value of equation *(2)*. The multiplier term *M* here is "$1 - (1+i)/(1+g)$". Multiplying and dividing by that *M* will create two parallel series, which when combined will have no unstated terms. Then simplifying algebraically, the series becomes

(3) $[1-(1+g)^n/(1+i)^n]/(i-g)$

So long as $i > g$ when *n* is infinite, the "$(1+g)^n/(1+i)^n$" term in equation *(3)* is infinitesimal and the equation becomes:

(4) $1/(i-g)$

which is the same as equation *(1)*.

Equation *(3)* becomes equation *(4)* only when *g* is less than the discount rate *i*. If $g > i$, the cash flows are growing faster than they are being discounted. An infinite stream of such cash flows will then cause a computed present value equal to infinity. The absurdity means that equations *(3)* and *(4)* have usable meaning only for $i > g$.

ing has been matching.[69] The function of matching is to re-analyze the uneven cash flows that really occur to come up with a smoother sample that might be said to be typical so that it can fit into the perpetuity assumption. Investments, for instance, tend to occur in big, uneven lumps and they are reanalyzed as depreciation expenses which have a more annual pattern. Future cash income and future cash outflow for expenses are accrued in the current period because the accruals yield a net income figure that is smoother and hopefully more "typical" than the actual cash flows.[70]

No Longer Need to Sample. There is, however, no longer a good reason why analysis of stock value needs to reshape accurate information about future cash inflows or outflows into the mold of a perpetuity. With calculators, the mathematics of discounting is now simple even with the exponents in a compound interest formula. With good spreadsheet programs readily at hand, any analyst and most investors could work well with information or projections about future cash flows, even if the known or projected future cash flows will not be even or perpetual.[71] Valuation always depends upon future cash flows, and any projection about the future will require some assumptions about continuity, shrinkage, or growth. Still, there is no longer any reason why information about the future needs to be shoehorned into a perpetuity mold, which will fit into the price-earnings formulas. When all financial information had to be forced into the format of a perpetuity to be "practical" at all, the distortion of price-earnings ratios might have been justifiable. Now, however, price-earnings ratios and matching too often badly misanalyze the known facts about the firm without the technological necessity.[72]

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69 *See generally* W.A. PATON & A.C. LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS (1940).

70 *See, e.g.*, Miguel de Capriles, *Modern Financial Accounting (Part I),* 37 N.Y.U. L. REV. 1001, 1015-18 (1962) (arguing, erroneously, that matching revenue and cost is a useful accounting convention for computing profits or losses since most businesses cannot await complete liquidation before determining income).

71 *See, e.g.*, ALFRED RAPPAPORT, CREATING SHAREHOLDER VALUE: THE NEW STANDARD FOR BUSINESS PERFORMANCE 45-48 (1986) (recommending that firms make their projected cash flows available electronically so that each shareholder can determine their value by his or her own discount rate).

72 *See, e.g.*, Johnson, *supra* note 7, at 379-80, 400-01 (arguing that GAAP accounting and price-earnings ratios misanalyze prepaid receipts and that to adjust accounting to abandon present value analysis for an inferior tool, price-earnings ratio analysis, is undesirable).

3. *Buffett's Anti-Cash Flow*

Buffett disparages discounted cash flow analysis, saying that cash flows "may serve as a shorthand of some utility in descriptions of certain real estate businesses or other enterprises that make huge outlays." "But 'cash flow' is meaningless in such businesses as manufacturing, retailing, extractive industries and utilities," Buffett argues, "because for them, *(c)* [average investment in maintaining unit volume and competitive position] is always significant."[73] From the floor at the Cardozo symposium, Charles Munger consistently argued against cash flow analysis of investments on the ground that such analysis ignored investment costs and counted revenue only.[74]

Discounted Present Value Cannot Ignore Negative Cash Flow. No analysis of discounted present value of future cash flow could ever ignore capital costs or any other cash outflow. Net present value includes present value of the costs or cash outflows as well as cash inflows. Capital costs are treated as cash outflows when they occur. It is reasonable under a simplified cash flow analysis to exclude future investment from analysis under a fair presumption that the cash outflow from the investment will be offset by the discounted present value of the cash flow that the investment will generate thereafter; rational investments generate a cash flow worth at least their cost. However, excluding future investment does not ignore the cash flow cost of an investment, but simply assumes the cash outflow and inflow will offset each other. Buffett's arguments imply that he misunderstands discounted present value, and discounted present value analysis is the only valid underlying theory of stock value.

B. *A Critique of Owner Earnings*

Owner Earnings. In his essays to Berkshire Hathaway shareholders, Buffett advocates "owner earnings" as an alternative measure of the performance of a firm. The owner earnings measure takes depreciation as a measure of capital cost out of the reported income figure and replaces it with a figure representing the average investments that a firm is expected to need to maintain its position in the industry. The measure is his alternative to GAAP earnings

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[73] *Buffett Essays*, *supra* note 34, at 186.

[74] *See generally Buffett Conversations*, *supra* note 59. Munger called financial analysis of cash flows "earnings before deducting anything," which misunderstands that cash flow analysis counts negative cash flows, too. *Id.* at 804.

and discounted present value analysis. Owner earnings is defined as:

> (a) reported earnings, *plus* [that is, adding back to undo the prior subtraction] (b) depreciation, depletion, amortization and certain other non-cash charges . . . *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.[75]

Depreciation is a real cost, Buffett concedes.[76] Depreciation in good theory measures the decline in (net present) value of a purchased asset or other capital. Buffett is adding back depreciation into earnings not to ignore the capital cost of a purchased asset, but because his adjustment *(c)* takes the place of depreciation as a measure of the cost of capital. Adjustment *(c)* subtracts from earnings the average amount that the firm would invest per year in a hypothetical world in which the firm maintains a constant competitive position and unit volume.

Preservation of Capital. Buffett's owner earnings measure of corporate performance follows a long tradition that defines income as residue available only after capital has been preserved. One widely quoted version defines income as "the maximum amount of value which [a person] can consume during a week, and still expect to be as well off at the end of the week as [the person] was at the beginning."[77] Applied to corporations, the tradition requires that net income "for possible distribution should be limited to that share of bookkeeping return which is appropriable and consumable [after some reasonable assurance that] the basic income-producing estate will remain intact."[78] Ultimately, defining income in terms of an intact estate could undoubtedly be traced back to feudal restrictions under which the knight occupying the manor and estate had to preserve the land and castle for the benefit of the next male heir.[79] Income, available for consumption by the current owners, was only the amount—originally just the harvests—that was available after capital had first been preserved.

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75 *See Buffett Essays*, *supra* note 34, at 184 (emphasis added).

76 *See id.* at 76.

77 Paul Rosenfield, *Correcting for Inflation and Value Changes*, *in* 1 ACCOUNTANTS' HANDBOOK § 24, at 21 (Lee J. Seidler & D.R. Carmichael eds., 6th ed. 1981) (quoting Sir John Hicks' "widely cited" definition of expected income of individuals).

78 R.G. Walker, *The Base-Stock Principle in Income Accounting,* HARV. BUS. REV., Autumn 1936, at 74, 85.

79 *See, e.g.*, THEODORE F.T. PLUNKETT, A CONCISE HISTORY OF THE COMMON LAW 476-525 (4th ed. 1948) (describing the history of the restraints on alienation of land in favor of the sovereign or lord).

Preserving Capital on a Fast Track. The owner earnings measure seems to be on an especially anti-distribution wing of the preserve capital tradition. Nothing is available for possible distribution to the owners (shareholders) under the owner earnings measure until after the corporation (management) keeps enough to fully maintain its long-term competitive position and unit volume. Capital that must be preserved is not just the amount originally invested by the owners nor the inflation-adjusted dollar amounts invested by owners nor even the amounts necessary to replace the current physical capital—plant and equipment. The firm must withhold from its owners enough capital to keep up with what might be a very rapidly rising escalator. In a competitive, rapidly changing industry, the firm may have to sprint as fast as it can just to stay up with the pack, so that it will never have any earnings or income available for its owners. The shareholders will be the owners, but devoid of any power or cash flow. The adjustment is not necessarily symmetrical, however, because if the industry is shrinking, adjustment *(c)* also identifies the capital to be preserved as the amount necessary to the corporation's unit volume so that capital may not shrink in line with the industry. Despite the name, owner earnings also do not represent distributions that are in fact made or made available to the owners. Even after computing the owner's share, management can choose to retain rather than distribute the owner earnings.

Perpetuity Assumption Still. While the owner earnings measure that Buffett proposes varies from GAAP earnings, both GAAP and the owner earnings measure fit into an appraisal of stock value only on the assumption that earnings will be perpetual. Both GAAP earnings and owner earnings require a multiplier, such as a price-earnings ratio, to be useful for valuation. Buffett is looking for a "normal" figure, just as accounting matching is looking for a typical or cross section figure. The only difference between GAAP and owner earnings is that Buffett's measure uses "average investment" on the assumption that the firm remains the same size, whereas GAAP uses depreciation. Both GAAP and owner earnings are shoehorning available information into the form of a perpetuity.

Mistiming: Average Rather Than Actual. The attempt to shoehorn real investments into an average figure that works for a perpetuity can do real harm to net present value calculations if the corporation is making investments in large bunches that do not fit the average pattern. Investments are negative cash flows when they occur. If the corporation makes big investments earlier than the average figure implies, then the negative cash flow from the investing has a more detrimental impact on present value than the average figure. Conversely, if the corporation incurs big negative cash flows later than the average figure implies, then the present value of the costs is lower than the average figure implies. The average figure artificially smooths out the investment cost into smaller annual costs. When the investments in fact come in big lumps, as they tend to do, any average figure will have the same net present value as the real investment outflows do only by sheer accident.

Virtual Investments. The owner earnings calculation also looks at hypothetical investments rather than at the real investments. The adjustment *(c)* in owner earnings subtracts the average investment the firm would make if it maintained its status quo in terms of competitive position and unit output. The adjustment ignores the actual investments that the firm will make in the future. It is rare for a firm to neither shrink nor expand. When a firm does not just maintain its position, then its actual investments will affect net present value in a way different from the effect implied by the adjustment *(c)* measure. For example, if a firm is growing dramatically, the owner earnings measure tells us to ignore the growth and count only the average investments the firm would have made had it not grown. The average investments to maintain the status quo will be much smaller than the real cash investments that the firm intends to make. Some rapidly growing firms that are making terrible investments will appear to be redeemed, inappropriately, by the owner earnings measure because their investments would be fine if they were charged only with the smaller status quo investment amounts. Conversely, some firms in mature or shrinking industries will be wisely shrinking, and giving good value for the amount invested as they shrink. Yet these firms will be deemed to be awful under the owner earnings measure because they will be charged with the average investment figure to maintain their size, which are much larger than the investments that they are really making. Adjustment *(c)*, by looking only to average hypothetical investments, will give inaccurate advice to real investors.

Inadministerable. Even if all this were different and the preservation of capital principle underlying owner earnings were a viable theory consistent with net present value, the measure still would not be a workable rule. Most corporations are shrinking or growing. If the corporation is changing, how is anyone to ascertain how much the corporation would plan to invest on average as if it were some other corporation that was not changing? Moreover, accounting for the benefit of investors has to be used by outside shareholders, who are purportedly the owners in the phrase owner earnings. How can outsider shareholders ascertain what some theoretical corporation would plan to invest if it were not growing or shrinking? For that matter, the owner earnings measure includes no indicia of risk or volatility, whereas information about diversifiable and nondiversifiable risk is plausibly the most crucial information that a corporation needs to provide to its shareholders and prospective investors.[80] Owner earnings may similarly produce a value figure that is correct on occasion, but like a stopped pocket watch this would be by happenstance.

Not for Owners. The drawbacks of owner earnings as a measure of the net present value of stock seem serious enough that the measure should be dismissed as an accounting tool for the benefit of investors. Owner earnings must be serving some other group than the owners and some other function than investment advice. Owner earnings seems to be staking out a moral position, that shareholders should not expect management to distribute anything to shareholders until it has preserved enough capital to maintain its competitive position and unit value. However, even that position seems unnecessary. Corporations sometimes rationally shrink. In any event, whatever its ulterior purpose, the owner earnings measure seems neither useful for investors nor motivated by a desire to account in their favor.

Conclusion

The function of financial accounting is to provide information to investors to aid them in the choice of investments. High standards of financial accounting are necessary to maintain a public market in which diverse public investors are willing to give capital to a corporation. High standards of accounting lower the cost of capital to the corporation. High standards of accounting also maintain an efficient market in which the stock price reflects the real merit of the investment and at the lowest possible price. High standards of accounting reduce waste and mistakes in the allocation of precious capital.

Warren Buffett has sometimes been an ally of the investor in maintaining high standards of accounting. He has argued elo-

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[80] *See* Hu, *supra* note 9, at 299-300.

quently that stock options are a part of compensation costs and that the costs need to be reflected in the corporation's income statements. Buffett, however, is also a manager and in his management role he has been willing to present misleading accounting—the pooling method of accounting for acquisitions—as if it were the better standard. Buffett, moreover, is no theorist of value, as shown by his disparagement of cash flow accounting and his alternative measure, owner earnings that simply is not workable. Buffett's success as an investor cannot be attributed to his superior accounting.