EBITDA ignores a real cost

Letters: 2000, 2002 · Difficulty: Intro

Summary

EBITDA (earnings before interest, taxes, depreciation and amortization) leaves out depreciation as if it were not a real cost. Buffett points out that the cash for plant and equipment is paid up front, before the assets produce anything, so depreciation is a very real expense.

2000 letter

(If it works, guess who's next.) We spent $272 million on flight si mulators in 2000, and we'll spend a similar amount this year. Anyone who thinks that the annual charges for depreciation don't reflect a real cost — every bit as real as payroll or raw materials — should get an internship at a simulator company. Every year we spend amounts equal to our depreciation charge simply to stay in the same economic place — and then spend additional sums to grow. And growth is in prospect for FSI as far as the eye can see.

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When Charlie and I read reports, we have no interest in pictures of personnel, plants or products. References to EBITDA make us shudder — does management think the tooth fairy pays for capital expenditures? We're very suspicious of accounting methodology that is vague or unclear, since too often that means management wishes to hide something.

2002 letter

There is seldom just one cockroach in the kitchen. Trumpeting EBITDA (earnings before interest, taxes, depreciation and amortization) is a particularly pernicious practice. Doing so implies that depreciation is not truly an expense, given that it is a "non-cash" charge. That's nonsense.

In truth, depreciation is a particularly unattractive expense because the cash outlay it represents is paid up front, before the asset acquired has delivered any benefits to the business. Imagine, if you will, that at the beginning of this year a company paid all of its employees for the next ten years of their service (in the way they would lay out cash for a fixed asset to be useful for ten years).

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 2000, 2002 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.