Purchase vs. pooling for acquisitions

Letters: 1999, 2000 · Difficulty: Advanced

Summary

Until 2001, U.S. GAAP allowed two methods for acquisitions. **Pooling** combined the two companies' book values and created no goodwill; the **purchase** method recorded assets at fair value and created goodwill that was then amortized against earnings. Managers favored pooling to avoid those charges. Today only the purchase (acquisition) method is allowed.

1999 letter

In the updated version of that table, which follows, we trace two key components of value. The first column lists our per-share ownership of investments (including cash and equivalents but excluding assets held in our financial p roducts operation) and the second column shows our per-share earnings from Berkshire's operatin g businesses before taxes and purchase-accounting adjustments (discussed on page 61), but after all interest and corporate expenses. The second column excludes all dividends, interest and capital gains that we realized from the investments presented in the first column.

…

This is currently a very contentious topic and, before the dust settles, Congress may even intervene (a truly terrible idea). When a company is acquired, generally accepted accounting principles ("GAAP") currently condone two ver y different ways of recording the transaction: "purchase" and "pooling." In a pooling, stock must be the currency; in a purchase, payment can be made in either cash or stock. Whatever the currency, managements usually detest purchase accounting because it almost always requires that a "goodwill" account be established and subsequently written off — a process that saddles earnings with a large annual charge that normally persists for decades. In contrast, pooling avoids a goodwill account, which is why managements love it.

Now, the Financial Accounting Standards Board ("FASB") has proposed an end to pooling, and many CEOs are girding for battle. It will be an important fight, so we'll venture some opinions.

…

And, if we run the business right, growth of that kind will probably continue for at least another 78 years. To escape from the fiction of goodwill charges, managers embrace the fiction of pooling. This accountin g convention is grounded in the poetic notion that when two rivers merge their streams become indistinguishable.

…

The total earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements. (in millions) Berkshire's Share of Net Earnings (after taxes and Pre-Tax Earnings minority interests) 1999 1998 1999 1998 Operating Earnings: Insurance Group: Underwriting — Reinsurance ..... $(1,440) $(21) $(927) $(14) Underwriting — GEICO ..... 24 269 16 175 Underwriting — Other Primary ..... 22 17 14 10 Net Investment Income ..... 2,482 974 1,764 731 Buffalo News ..... 55 53 34 32 Finance and Financial Products Businesses ..... 125 205 86 133 Flight Services ..... 225 181 132 110 (1) (1) Home Furnishings ..... 79 72 46 41 (2) (2) International Dairy Queen ..... 56 58 35 35 Jewelry ..... 51 39 31 23 Scott Fetzer (excluding finance operation) ..... 147 137 92 85 See's Candies ..... 74 62 46 40 Shoe Group ..... 17 33 11 23 Purchase-Accounting Adjustments ..... (739) (123) (648) (118) Interest Expense .....(3) (109) (100) (70) (63) Shareholder-Designated Contributions .....

2000 letter

We are 180 degrees from that point. 15 Sources of Reported Earnings The table that follows shows t he main sources of Berkshire's reported earnings. In this presentation, purchase-accounting adjustments are not assigned to the specific businesses to which they apply, but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them.

…

(in millions) Berkshire's Share of Net Earnings (after taxes and Pre-Tax Earnings minority interests) 2000 1999 2000 1999 Operating Earnings: Insurance Group: Underwriting – Reinsurance..... . $(1,399) $(1,440) $(899) $(927) Underwriting – GEICO .... (224) 24 (146) 16 Underwriting – Other Primary ..... 38 22 24 14 Net Investment Income .... 2,747 2,482 1,929 1,764 Finance and Financial Products Business ..... 556 125 360 86 Flight Services..... ..... 213 225 126 132 MidAmerican Energy (76% owned)..... 197 -- 109 -- Retail Operations..... ..... 175 130 104 77 Scott Fetzer (excluding finance operation) ..... 122 147 80 92 Other Businesses .... 225 210 134 131 Purchase-Accounting Adjustments..... (881) (739) (843) (648) Corporate Interest Expense ....

…

As we calculate these, they consist of: (1) the operating earnings reported on page 15; plus; (2) our share of the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. When tabulating "operating earnings" here, we exclude purchase-accounting adjustments as well as capital gains and other major non-recurring items. The following table sets forth our 2000 look-through earnings, though I warn you that the figures can be no more than approximate, since they are based on a number of judgment calls.

…

Journalism’s First Principle should require that the media be scrupulous in deciding what that will be. Miscellaneous In last year’s report we examined the battle then raging over the use of “pooling” in accounting for mergers. It seemed to us that both sides were voicing arguments that were strong in certain respects and seriously flawed in others.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1999, 2000 (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.