Unrealized gains in net income

Letters: 2017, 2018, 2024 · Difficulty: Intermediate

Summary

Since 2018, U.S. GAAP requires changes in the market value of stocks a company holds to be reported in **net income**, even if nothing is sold. For Berkshire this makes net income swing by billions each quarter. Buffett tells shareholders to focus on **operating earnings**, which leave these gains and losses out.

2017 letter

But, in still another interruption, I must first tell you about a new accounting rule – a generally accepted accounting principle (GAAP) – that in future quarterly and annual reports will severely distort Berkshire's net income figures and very often mislead commentators and investors. The new rule says that the net change in unrealized investment gains and losses in stocks we hold must be included in all net income figures we report to you. That requirement will produce some truly wild and capricious swings in our GAAP bottom-line.

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For analytical purposes, Berkshire's "bottom-line" will be useless. The new rule compounds the communication problems we have long had in dealing with the realized gains (or losses) that accounting rules compel us to include in our net income. In past quarterly and annual press releases, we have regularly warned you not to pay attention to these realized gains, because they – just like our unrealized gains – fluctuate randomly. That's largely because we sell securities when that seems the intelligent thing to do, not because we are trying to influence earnings in any way.

As a result, we sometimes have reported substantial realized gains for a period when our portfolio, overall, performed poorly (or the converse). *All per-share figures used in this report apply to Berkshire's A shares. Figures for the B shares are 1/1500 th of those shown for the A shares. 3 With the new rule about unrealized gains exacerbating the distortion caused by the existing rules applying to realized gains, we will take pains every quarter to explain the adjustments you need in order to make sense of our numbers. But televised commentary on earnings releases is often instantaneous with their receipt, and newspaper headlines almost always focus on the year-over-year change in GAAP net income.

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The shares had a yearend market value of $25.3 billion, and a cost basis of $9.8 billion. 12/31/17 Shares* Company Percentage of Company Owned Cost** Market (in millions) 151,610,700 American Express Company ..... 17.6 $ 1,287 $ 15,056 166,713,209 Apple Inc. ..... 3 . 3 20,961 28,213 700,000,000 Bank of America Corporation ..... 6 . 8 5,007 20,664 53,307,534 The Bank of New York Mellon Corporation ..... 5 . 3 2,230 2,871 225,000,000 BYD Company Ltd. ..... 8 . 2 2 3 2 1,961 6,789,054 Charter Communications, Inc. ..... 2 . 8 1,210 2,281 400,000,000 The Coca-Cola Company ..... 9 . 4 1,299 18,352 53,110,395 Delta Airlines Inc. ..... 7 . 4 2,219 2,974 44,527,147 General Motors Company ..... 3 . 2 1,343 1,825 11,390,582 The Goldman Sachs Group, Inc. ..... 3 . 0 6 5 4 2,902 24,669,778 Moody's Corporation ..... 12.9 248 3,642 74,587,892 Phillips 66 ..... 14.9 5,841 7,545 47,659,456 Southwest Airlines Co. ..... 8 . 1 1,997 3,119 103,855,045 U.S. Bancorp ..... 6 . 3 3,343 5,565 482,544,468 Wells Fargo & Company ..... 9 . 9 11,837 29,276 Others ..... 14,968 24,294 Total Common Stocks Carried at Market ..... $ 74,676 $ 170,540 * Excludes shares held by pension funds of Berkshire subsidiaries. ** This is our actual purchase price and also our tax basis; GAAP "cost" differs in a few cases because of write-downs that have been required under GAAP rules. 9 Some of the stocks in the table are the responsibility of either Todd Combs or Ted Weschler, who work with me in managing Berkshire's investments. Each, independently of me , manages more than $12 billion; I usually learn about decisions they have made by looking at monthly portfolio summaries.

2018 letter

To the Shareholders of Berkshire Hathaway Inc.: Berkshire earned $4.0 billion in 2018 utilizing generally accepted accounting principles (commonly called “GAAP”). The components of that figure are $24.8 billion in operating earnings, a $3.0 billion non-cash loss from an impairment of intangible assets (arising almost entirely from our equity interest in Kraft Heinz), $2.8 billion in realized capital gains from the sale of investment securities and a $20.6 billion loss from a reduction in the amount of unrealized capital gains that existed in our investment holdings. A new GAAP rule requires us to include that last item in earnings. As I emphasized in the 2017 annual report, neither Berkshire’s Vice Chairman, Charlie Munger, nor I believe that rule to be sensible.

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In the second and third quarters, we reported profits of $12 billion and $18.5 billion. In complete contrast to these gyrations, the many businesses that Berkshire owns delivered consistent and satisfactory operating earnings in all quarters. For the year, those earnings exceeded their 2016 high of $17.6 billion by 41%. Wide swings in our quarterly GAAP earnings will inevitably continue.

That’s because our huge equity portfolio – valued at nearly $173 billion at the end of 2018 – will often experience one-day price fluctuations of $2 billion or more, all of which the new rule says must be dropped immediately to our bottom line. Indeed, in the fourth quarter, a period of high volatility in stock prices, we experienced several days with a “profit” or “loss” of more than $4 billion. Our advice? Focus on operating earnings, paying little attention to gains or losses of any variety.

My saying that in no way diminishes the importance of our investments to Berkshire.

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A third category of Berkshire’s business ownership is a quartet of companies in which we share control with other parties. Our portion of the after-tax operating earnings of these businesses – 26.7% of Kraft Heinz, 50% of Berkadia and Electric Transmission Texas, and 38.6% of Pilot Flying J – totaled about $1.3 billion in 2018. In our fourth grove, Berkshire held $112 billion at yearend in U.S.

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These are liabilities that we will eventually pay but that are meanwhile interest-free. As I indicated earlier, about $14.7 billion of our $50.5 billion of deferred taxes arises from the unrealized gains in our equity holdings. These liabilities are accrued in our financial statements at the current 21% corporate tax rate but will be paid at the rates prevailing when our investments are sold.

2024 letter

Both, however, have much left to accomplish. Late in the year we increased our ownership of the utility operation from about 92% to 100% at a cost of roughly $3.9 billion, of which $2.9 billion was paid in cash with a balance in Berkshire “B” shares. * * * * * * * * * * * * All told, we recorded operating earnings of $47.4 billion in 2024. We regularly – endlessly, some readers may groan – emphasize this measure rather than the GAAP-mandated earnings that are reported on page K-68. Our measure excludes capital gains or losses on the stocks and bonds we own, whether realized or unrealized.

Over time, we think it highly likely that gains will prevail – why else would we buy these securities? – though the year-by-year numbers will swing wildly and unpredictably.

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EBITDA, a flawed favorite of Wall Street, is not for us. (in $ millions) 2024 2023 Insurance-underwriting ..... $ 9,020 $ 5,428 Insurance-investment income ..... 13,670 9,567 BNSF ..... 5,031 5,087 Berkshire Hathaway Energy ..... 3,730 2,331 Other controlled businesses ..... 13,072 13,362 Non-controlled businesses* ..... 1,519 1,750 Other** ..... 1,395 (175) Operating earnings ..... $47,437 $37,350 * Includes certain businesses in which Berkshire had between a 20% and 50% ownership such as Kraft Heinz, Occidental Petroleum and Berkadia. ** Includes foreign currency exchange gains of approximately $1.1 billion in 2024 and approximately $211 million in 2023 produced by our usage of non-U.S. dollar-denominated debt. Surprise, Surprise!

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All are at fixed rates, no “floaters.” Greg and I have no view on future foreign exchange rates and therefore seek a position approximating currency-neutrality. We are required, however, under GAAP rules to regularly recognize in our earnings a calculation of any gains or losses in the yen we have borrowed and, at yearend, had included $2.3 billion of after-tax gains due to dollar strength of which $850 million occurred in 2024. I expect that Greg and his eventual successors will be holding this Japanese position for many decades and that Berkshire will find other ways to work productively with the five companies in the future.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 2017, 2018, 2024 (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.