"Adjusted" earnings

Letters: 2016 · Difficulty: Intro

Summary

Many companies feature **"adjusted" earnings** that leave out costs such as stock-based compensation or restructuring. Buffett argues these are real costs, and that excluding them makes performance look better than it is.

2016 letter

Moreover, a wide disparity will prevail for decades. All that said, Charlie and I love our railroad, which was one of our better purchases. ********** Too many managements – and the number seems to grow every year – are looking for any means to report, and indeed feature , "adjusted earnings" that are higher than their company's GAAP earnings. There are many ways for practitioners to perform this legerdemain. Two of their favorites are the omission of "restructuring costs" and "stock-based compensation" as expenses.

Charlie and I want managements, in their commentary , to describe unusual items – good or bad – that affect the GAAP numbers. After all, the reason we look at these numbers of the past is to make estimates of the future. But a management that regularly attempts to wave away very real costs by highlighting "adjusted per-share earnings" makes us nervous. That's because bad behavior is contagious: CEOs who overtly look for ways to report high numbers tend to foster a culture in which subordinates strive to be "helpful" as well.

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And too many analysts and journalists fall for this baloney. To say "stock-based compensation" is not an expense is even more cavalier. CEOs who go down that road are, in effect, saying to shareholders, "If you pay me a bundle in options or restricted stock, don't worry about its effect on earnings. I'll 'adjust' it away." To explore this maneuver further, join me for a moment in a visit to a make-believe accounting laboratory whose sole mission is to juice Berkshire's reported earnings.

Imaginative technicians await us, eager to show their stuff. 16 Listen carefully while I tell these enablers that stock-based compensation usually comprises at least 20% of total compensation for the top three or four executives at most large companies. Pay attention, too, as I explain that Berkshire has several hundred such executives at its subsidiaries and pays them similar amounts, but uses only cash to do so. I further confess that, lacking imagination, I have counted all of these payments to Berkshire's executives as an expense. My accounting minions suppress a giggle and immediately point out that 20% of what is paid these Berkshire managers is tantamount to "cash paid in lieu of stock-based compensation" and is therefore not a "true" expense.

So – presto! – Berkshire, too, can have "adjusted" earnings. Back to reality: If CEOs want to leave out stock-based compensation in reporting earnings, they should be required to affirm to their owners one of two propositions: why items of value used to pay employees are not a cost or why a payroll cost should be excluded when calculating earnings. During the accounting nonsense that flourished during the 1960s, the story was told of a CEO who, as his company revved up to go public, asked prospective auditors, "What is two plus two?" The answer that won the assignment, of course, was, "What number do you have in mind?" Finance and Financial Products Our three leasing and rental operations are conducted by CORT (furniture), XTRA (semi-trailers), and Marmon (primarily tank cars but also freight cars, intermodal tank containers and cranes).

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But the results for their investors were dismal – really dismal. And, alas, the huge fixed fees charged by all of the funds and funds-of-funds involved – fees that were totally unwarranted by performance – were such that their managers were showered with compensation over the nine years that have passed.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 2016 (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.