Shareholder Letters: Accounting Themes

Owner earnings

Berkshire letters: 1986

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What the Letter Says

> *"We consider the owner earnings figure, not the GAAP figure, to be the relevant item for valuation purposes."*
>
> Warren E. Buffett, 1986 letter

- Key letters: 1986
- Course fit: ACC250 Ch9 · ACC531 — · Difficulty: Intermediate

Step 1: Start with Net Income

- Net income (GAAP) includes **non-cash** charges such as depreciation and amortization (D&A).

EX. Net income $100; D&A $40; capital spending needed just to maintain the business $50.

Step 2: Add Back Non-cash Charges

	Amount
Net income	$100
+ Depreciation and amortization	40
Subtotal	$140

- D&A reduced net income, but no cash left the business this year.

Step 3: Subtract Maintenance Capex

	Amount
Net income	$100
+ Depreciation and amortization	40
− Maintenance capital spending	(50)
Owner earnings	$90

- **Maintenance** capex: what must be spent just to stay competitive (not growth).

Back to the Letter

- Buffett (1986): owner earnings, not GAAP earnings, are what matter for **valuing** a business.
- Adding back D&A without subtracting capex (like EBITDA) overstates what owners can take out.
- Maintenance capex is an estimate: management has to judge it.

Questions

1. Net income is $100, depreciation and amortization are $40, and the capital spending needed just to maintain the business is $50. What are owner earnings (net income + D&A − maintenance capital spending)?
2. Compared with EBITDA, owner earnings...

   A. ignores depreciation

   B. adds back income taxes

   C. is always larger

   D. subtracts the capital spending needed to keep the business running

Sources

- Warren E. Buffett, 1986 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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