Shareholder Letters: Accounting Themes

EBITDA ignores a real cost

Berkshire letters: 2000, 2002

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What the Letter Says

> *"References to EBITDA make us shudder — does management think the tooth fairy pays for capital expenditures?"*
>
> Warren E. Buffett, 2000 letter

- Key letters: 2000, 2002
- Course fit: ACC250 Ch9 · ACC531 — · Difficulty: Intro

Step 1: Build EBITDA from Net Income

- **EBITDA** = Earnings Before Interest, Taxes, Depreciation and Amortization.

EX. Net income $50, interest $10, income taxes $20, D&A $30.

	Amount
Net income	$50
+ Interest expense	10
+ Income tax expense	20
+ Depreciation and amortization	30
EBITDA	$110

Step 2: Where Does Depreciation Come From?

EX. Buy a truck for $300 cash; 10-year life (no salvage value).

Year 1:	PPE (+A)	300	
	Cash (−A)		300
Each Dec 31:	Depreciation Expense (+E)	30	
	Accumulated Depreciation (+xA, −A)		30

- The **cash** was paid up front; depreciation spreads that cost over 10 years.

Step 3: What EBITDA Leaves Out

	Year 1
Cash paid for the truck	$300
Depreciation in EBITDA	$0

- EBITDA treats depreciation as if it were not a cost → the truck looks free.
- Someday the truck must be replaced → real cash.

Back to the Letter

- Buffett (2000): “does management think the tooth fairy pays for capital expenditures?”
- Buffett (2002): trumpeting EBITDA implies depreciation is not truly an expense.

Questions

1. Net income $50, interest $10, income taxes $20, depreciation and amortization $30. What is EBITDA?
2. Why does Buffett call depreciation a real cost even though it is a “non-cash” expense?

   A. Depreciation is a liability

   B. The cash was paid up front when the asset was bought

   C. Depreciation is paid in cash every year

   D. Depreciation increases taxes owed

Sources

- Warren E. Buffett, 2000 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 2002 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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