Shareholder Letters: Accounting Themes

Earnings management

Berkshire letters: 1998, 1992, 2000

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What the Letter Says

> *“The distortion du jour is the “restructuring charge,” an accounting entry that … too often is a device for manipulating earnings.”*
>
> Warren E. Buffett, 1998 letter

- Key letters: 1998, 1992, 2000
- Course fit: ACC250 — · ACC531 Fraud risk · Difficulty: Intermediate

Step 1: The Restructuring Charge

- **Restructuring charge**: expense for closing plants, cutting jobs, ... recorded when the plan is made.
- **Big bath**: charge too much in a bad year, so future years look better.

EX. Year 1 is a bad year. Management books a $40 restructuring charge; only $30 will actually be needed.

Step 2: The Entries

Year 1:	Restructuring Expense (+E)	40	
	Restructuring Liability (+L)		40
Year 2:	Restructuring Liability (−L)	30	
	Cash (−A)		30
Year 2:	Restructuring Liability (−L)	10	
	Restructuring Expense (−E)		10

- The extra $10 is reversed in Year 2 → Year 2 profit goes **up** by $10.

Step 3: Compare the Two Years

EX. Profit before the charge: $80 each year.

	Year 1	Year 2
Honest: $30 charge	$50	$80
Big bath: $40 charge, $10 reversed	$40	$90

- Same business, same cash. Only the timing of expenses changed.

Back to the Letter

- Buffett (1998): the restructuring charge is “the distortion du jour,” too often a device for manipulating earnings.
- “We prefer a lumpy 15% return to a smooth 12%.”
- Auditors (ACC531): test reserve reversals; very smooth earnings are a red flag.

Questions

1. A company books an unusually large restructuring charge in a bad year (a "big bath"). What does this most likely do to the following years' reported earnings?

   A. Has no effect

   B. Eliminates all future expenses

   C. Makes them look better, because future costs were charged early

   D. Makes them look worse

2. Buffett writes, "We prefer a lumpy 15% return to a smooth 12%." Why should an auditor be skeptical of very smooth earnings?

   A. Smooth earnings are illegal under GAAP

   B. Auditors cannot audit smooth earnings

   C. Smooth earnings mean no taxes are paid

   D. Smoothness can come from adjusting estimates and reserves rather than from the business

Sources

- Warren E. Buffett, 1998 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 1992 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 2000 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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