Shareholder Letters: Accounting Themes

Pension return assumptions

Berkshire letters: 2007, 2016

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What the Letter Says

> *“Other accounting choices remain – important among these the investment-return assumption a company uses in calculating pension expense.”*
>
> Warren E. Buffett, 2007 letter

- Key letters: 2007, 2016
- Course fit: ACC250 — · ACC531 Estimates · Difficulty: Advanced

Step 1: What Pension Expense Includes

- Pension expense = cost of benefits earned this year + interest on the obligation – **expected return** on plan assets.
- The expected return is an **assumption** chosen by management.

Step 2: Change the Assumption

EX. Plan assets $1,000 million.

Assumed return	Expected return	Effect on pension expense
5%	$50M	reduces expense by $50M
8%	$80M	reduces expense by $80M

- 8% instead of 5% → expense **$30 million lower**, earnings higher. Nothing real changed.

Step 3: Is the Assumption Reasonable?

- Compare it with the plan's asset mix: bonds and cash cannot earn 8%.
- Auditors (ACC531): an **estimate** → test management's assumptions.

Back to the Letter

- Buffett (2007): the average S&P 500 company assumed about 8% in 2006.
- About 28% of pension assets were bonds and cash, which could be expected to return no more than 5%.

Questions

1. Pension plan assets are $1,000 million. If the company assumes an 8% expected return instead of 5%, by how much does reported pension expense fall ($ millions)?
2. A higher assumed return on pension assets...

   A. increases the cash paid to retirees

   B. lowers pension expense and raises reported earnings

   C. raises pension expense

   D. has no effect on earnings

Sources

- Warren E. Buffett, 2007 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 2016 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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