Shareholder Letters: Accounting Themes

Derivatives and mark-to-market

Berkshire letters: 2002, 2008

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What the Letter Says

> *""Mark-to-market" then turned out to be truly "mark-to-myth." ... Derivatives are financial weapons of mass destruction."*
>
> Warren E. Buffett, 2002 letter

- Key letters: 2002, 2008
- Course fit: ACC250 — · ACC531 Fair value · Difficulty: Advanced

Step 1: Fair Value Each Period

- **Derivative**: a contract whose value depends on something else (interest rates, stock prices, ...).
- Recorded at **fair value**; changes go into earnings.

EX. A contract is worth +$20 million at the start of the year and −$15 million at year-end.

Step 2: The Gain or Loss

	$ millions
Fair value, end of year	(15)
− Fair value, start of year	(20)
Loss for the year	(35)

Step 3: Where Does Fair Value Come From?

	Fair value from
Traded on an exchange	Market price (mark-to-market)
No active market	Management's model (mark-to-model)

- Change one assumption → a different "profit." Hard to audit (ACC531).

Back to the Letter

- Buffett (2002): mark-to-market “turned out to be truly mark-to-myth”; derivatives are “financial weapons of mass destruction.”
- Buffett (2008), after the financial crisis: “Derivatives are dangerous.”

Questions

1. A derivative contract had a fair value of +$20 million at the start of the year and −$15 million at year-end. What gain (loss) is reported for the year ($ millions; use a minus sign for a loss)?
2. Why are many derivatives hard to audit?

   A. They are recorded at historical cost

   B. With no active market, fair value comes from management's models and assumptions

   C. Derivatives are never recorded on the balance sheet

   D. They are always worth zero

Sources

- Warren E. Buffett, 2002 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 2008 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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