Shareholder Letters: Accounting Themes

Inflation and reported returns

Berkshire letters: 1979, 1980, 1981

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What the Letter Says

> *“In past reports we have explained how inflation has caused our apparently satisfactory long-term corporate performance to be illusory as a measure of true investment results for our owners.”*
>
> Warren E. Buffett, 1981 letter

- Key letters: 1979, 1980, 1981
- Course fit: ACC250 — · ACC531 — · Difficulty: Advanced

Step 1: Depreciation at Old Prices

EX. A machine bought 10 years ago for $100 (10-year life). A new one now costs $200.

	Per year
Depreciation recorded (historical cost)	$10
Cost to replace, spread over 10 years	$20

Step 2: Reported Profit Is Overstated

	Reported	At today's prices
Profit before depreciation	$50	$50
− Depreciation	(10)	(20)
Profit	$40	$30

- Same for inventory: cost of goods sold uses older, lower prices.

Step 3: Real Return

	%
Return on equity	12%
− Inflation	(10%)
Real return (roughly)	2%

Back to the Letter

- Buffett (1979–1981): with inflation above 10%, good-looking returns were “illusory” for owners.
- Historical cost: reliable, but it can mislead when prices change fast.

Questions

1. A company earns a 12% return on equity while inflation is 10%. Roughly what is the real (inflation-adjusted) return, in %?
2. Why do historical-cost financial statements overstate earnings when prices rise?

   A. Revenue is recorded at old prices

   B. Assets are marked to market

   C. Taxes are ignored

   D. Depreciation and cost of goods sold are based on older, lower prices

Sources

- Warren E. Buffett, 1979 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 1980 letter (berkshirehathaway.com/letters)
- Warren E. Buffett, 1981 letter (berkshirehathaway.com/letters)
- Reading packet and question sheet for this theme

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