Inflation and reported returns

Berkshire letters: 1979, 1980, 1981 · Difficulty: Advanced

> *"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." (1981)*

1. A company earns a 12% return on equity while inflation is 10%. Roughly what is the real (inflation-adjusted) return, in %? **2**

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

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1979, 1980, 1981 (berkshirehathaway.com/letters). Quotation © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. Numbers in the questions are made up unless stated.