Owner earnings

Berkshire letters: 1986 · Difficulty: Intermediate

Summary

Owner earnings = reported earnings + depreciation, depletion, amortization and other non-cash charges − the capital spending needed to keep the business competitive. Buffett argues this, not GAAP earnings, is what matters for valuing a business, because some non-cash charges are not real costs while maintenance capital spending is.

1986 letter

And, if a business is worth some given multiple of earnings, was Scott Fetzer worth considerably more the day before we bought it than it was worth the following day? If we think through these questions, we can gain some insights about what may be called "owner earnings." These represent (a) reported earnings plus (b) depreciation, depletion, amortization, and certain other non-cash charges such as Company N's items (1) and (4) less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume. (If the business requires additional working capital to maintain its competitive position and unit volume, the increment also should be included in (c) . However, businesses following the LIFO inventory method usually do not require additional working capital if unit volume does not change.) Our owner-earnings equation does not yield the deceptively precise figures provided by GAAP, since (c) must be a guess - and one sometimes very difficult to make.

Despite this problem, we consider the owner earnings figure, not the GAAP figure, to be the relevant item for valuation purposes - both for investors in buying stocks and for managers in buying entire businesses. We agree with Keynes's observation: "I would rather be vaguely right than precisely wrong." The approach we have outlined produces "owner earnings" for Company O and Company N that are identical, which means valuations are also identical, just as common sense would tell you should be the case. This result is reached because the sum of (a) and (b) is the same in both columns O and N, and because (c) is necessarily the same in both cases. And what do Charlie and I, as owners and managers, believe is the correct figure for the owner earnings of Scott Fetzer?

Under current circumstances, we believe (c) is very close to the "old" company's (b) number of $8.3 million and much below the "new" company's (b) number of $19.9 million. Therefore, we believe that owner earnings are far better depicted by the reported earnings in the O column than by those in the N column. In other words, we feel owner earnings of Scott Fetzer are considerably larger than the GAAP figures that we report. That is obviously a happy state of affairs.

…

Most managers probably will acknowledge that they need to spend something more than (b) on their businesses over the longer term just to hold their ground in terms of both unit volume and competitive position. When this imperative exists - that is, when (c) exceeds (b) - GAAP earnings overstate owner earnings. Frequently this overstatement is substantial.

…

(The two items are not identical, of course. For example, at See's we annually make capitalized expenditures that exceed depreciation by $500,000 to $1 million, simply to hold our ground competitively.) Our conviction about this point is the reason we show our amortization and other purchase-price adjustment items separately in the table on page 8 and is also our reason for viewing the earnings of the individual businesses as reported there as much more closely approximating owner earnings than the GAAP figures. Questioning GAAP figures may seem impious to some.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1986 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.