Earnings management

Berkshire letters: 1998, 1992, 2000 · Difficulty: Intermediate

Summary

Buffett warns against **managing earnings**: booking oversized “restructuring charges” (a “big bath”) so later years look better, or adjusting estimates to make results smooth. He prefers honest, lumpy results. For auditors, unusually smooth earnings and large one-time charges are signals of possible manipulation.

1998 letter

In effect, a reinsurer gets paid for absorbing the volatility that the client insurer wants to shed. Ironically, though, a publicly-held reinsurer gets graded by both its owners and those who evaluate its credit on the smoothness of its own results. Wide swings in earnings hurt both credit ratings and p/e ratios, even when the business that produces such swings has an expectancy of satisfactory profits over time.

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We will simply ask the company to exercise the discipline of the past while increasing the proportion of its business that is retained, expanding its product line, and widening it s geographical coverage — making these moves in recognition of Berkshire’s financial strength and tolerance for wide swings in earnings. As we’ve long said, we prefer a lumpy 15% return to a smooth 12%. Over time, Ron and his team will maximize General Re’s new potential.

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Its opponents even enlisted Congress in the fight, pushing the case that inflated figures were in the national interest. Still, I believe that the behavior of managements has been even worse when it comes to restructurings and merger accounting. Here, many managements purposefully work at manipulating numbers and deceiving investors. And, as Michael Kinsley has said about Washington: “The scandal isn’t in what’s done that’s illegal but rather in what’s legal.” It was once relatively easy to tell the good guys in accounting from the bad: The late 1960's, for example, brought on an orgy of what one charlatan dubbed “bold, imaginative accounting” (the practice of which , incidentally, made him loved for a time by Wall St reet because he never missed expectations).

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In recent years, probity has eroded. Many major corporations still play things straight, but a significant and growing number of otherwise high-grade managers — CEOs you would be happy to have as spouses for you r children or as trustees under your will — have come to the view that it’s okay to manipulate earnings to satisfy what they believe are Wall Street’s desires. Indeed, many CEOs think this kind of manipulation is not only okay, but actually their duty. These managers start with the assumption, all too common, that their job at all times is to encourage the highest stock price possible (a premise with which we adamantly disagree).

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Call this behavior Son of Gresham: Ba d accounting drives out good. The distortion du jour is the “restructuring charge,” an accounting entry that can, of course, be legitimate but that too often is a device for manipulating earnings. In this bit of legerdemain, a large chunk of costs that should properly be attributed to a number of years is dumped into a single quarter, typically one already fated to disappoint investors.

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The golfer, playing alone with a cooperative caddy-auditor, should defer the recording of bad holes, take four 80s, accept the plaudits he gets for such athleticism and consistency, and then turn in a fifth card carrying a 140 score. After rectifying his earlier scorekeeping sins with this “big bath,” he may mumble a few apologies but will refrain from returning the sums he has previously collected from comparing scorecards in the clubhouse. (The caddy, need we add,

will have acquired a loyal patron.) Unfortunately, CEOs who use variations of these scoring schemes in real life tend to become addicted to the games they're playing — after all, it' s easier to fiddle with the scorecard than to spend hours on the practice tee — and never muster the will to give them up.

1992 letter

The owner of the acquiree then insisted on one other condition: "You must promise me," he said in effect, "that once our merger is done and I have become a major shareholder, you'll never again make a deal this dumb." You will remember that our goal is to increase our per-share intrinsic value - for which our book value is a conservative, but useful, proxy - at a 15% annual rate. This objective, however, cannot be attained in a smooth manner. Smoothness is particularly elusive because of the accounting rules that apply to the common stocks owned by our insurance companies, whose portfolios represent a high proportion of Berkshire's net worth. Since 1979, generally accepted accounting principles (GAAP) have required that these securities be valued at their market prices (less an adjustment for tax on any net unrealized appreciation) rather than at the lower of cost or market.

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("Fanaticism," said Santyana, "consists of redoubling your effort when you've forgotten your aim.") Ultimately, even the most optimistic manager must face reality. Standing knee-deep in unresponsive toads, he then announces an enormous "restructuring" charge. In this corporate equivalent of a Head Start program, the CEO receives the education but the stockholders pay the tuition.

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Even so, there is an important, and difficult to deal with, difference between the two: A bond has a coupon and maturity date that define future cash flows; but in the case of equities, the investment analyst must himself estimate the future "coupons." Furthermore, the quality of management affects the bond coupon only rarely - chiefly when management is so inept or dishonest that payment of interest is suspended. In contrast, the ability of management can dramatically affect the equity "coupons." The investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase - irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value. Moreover, though the value equation has usually shown equities to be cheaper than bonds, that result is not inevitable: When bonds are calculated to be the more attractive investment, they should be bought.

2000 letter

This tiny band works miracles. In 2000 it handled all of the details connected with our eight acquisitions, processed extensive regulatory and tax filings (our tax return covers 4,896 pages), smoothly produced an annual meeting to which 25,000 tickets were issued, and accurately dispensed checks to 3,660 charities designated by our shareholders. In addition, the group dealt with all the routine tasks served up by a company with a revenue runrate of $40 billion and more than 300,000 owners.

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A notable exception to this never-look-back approach is that of The Washington Post Company, which unfailingly and objectively reviews its acquisitions three years after they are made. Elsewhere, triumphs are trumpeted, but dumb decisions either get no follow-up or are rationalized. 11 The financial consequences of these boners are regularly dumped into massive restructuring charges or write-offs that are casually waved off as "nonrecurring." Managements just love these. Indeed, in recent years it has seemed that no earnings statement is complete without them.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1998, 1992, 2000 (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.