Economic vs. accounting goodwill

Berkshire letters: 1983, 1999, 2015 · Difficulty: Intermediate

Summary

When one company buys another for more than the fair value of its identifiable net assets, the excess is recorded as goodwill. Buffett separates this **accounting goodwill** from **economic goodwill**: the ability of a great business to earn high returns on its tangible assets. Economic goodwill that a company builds itself never appears on its balance sheet, so book value can understate what a business is worth.

1983 letter

At the end of 1983, the market value of this latter group exceeded carrying value by $70 million pre-tax, or about $50 million after tax. This excess belongs in our intrinsic business value, but is not included in the calculation of book value; (2) More important, we own several businesses that possess economic Goodwill (which is properly includable in intrinsic business value) far larger than the accounting Goodwill that is carried on our balance sheet and reflected in book value. Goodwill, both economic and accounting, is an arcane subject and requires more explanation than is appropriate here. The appendix that follows this letter - Goodwill and its Amortization: The Rules and The Realities - explains why economic and accounting Goodwill can, and usually do, differ enormously.

You can live a full and rewarding life without ever thinking about Goodwill and its amortization. But students of investment and management should understand the nuances of the subject. My own thinking has changed drastically from 35 years ago when I was taught to favor tangible assets and to shun businesses whose value depended largely upon economic Goodwill. This bias caused me to make many important business mistakes of omission, although relatively few of commission.

Keynes identified my problem: The difficulty lies not in the new ideas but in escaping from the old ones. My escape was long delayed, in part because most of what I had been taught by the same teacher had been (and continues to be) so extraordinarily valuable. Ultimately, business experience, direct and vicarious, produced my present strong preference for businesses that possess large amounts of enduring Goodwill and that utilize a minimum of tangible assets. I recommend the Appendix to those who are comfortable with accounting terminology and who have an interest in understanding the business aspects of Goodwill. Whether or not you wish to tackle the Appendix, you should be aware that Charlie and I believe that Berkshire possesses very significant economic Goodwill value above that reflected in our book value.

Sources of Reported Earnings The table below shows the sources of Berkshire's reported earnings.

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All of the significant gains and losses attributable to unusual sales of assets by any of the business entities are aggregated with securities transactions on the line near the bottom of the table, and are not included in operating earnings. (We regard any annual figure for realized capital gains or losses as meaningless, but we regard the aggregate realized and unrealized capital gains over a period of years as very important.) Furthermore, amortization of Goodwill is not charged against the specific businesses but, for reasons outlined in the Appendix, is set forth as a separate item. Net Earnings Earnings Before Income Taxes After Tax ---------- ---------- Total Berkshire Share Berkshire Share ---------- ---------- ---------- 1983 1982 1983 1982 1983 1982 -------- -------- -------- -------- -------- -------- (000s omitted) Operating Earnings: Insurance Group: Underwriting ..... $(33,872) $(21,558) $(33,872) $(21,558) $(18,400) $(11,345) Net Investment Income ... 43,810 41,620 43,810 41,620 39,114 35,270 Berkshire-Waumbec Textiles (100) (1,545) (100) (1,545) (63) (862) Associated Retail Stores .. 697 914 697 914 355 446 Nebraska Furniture Mart(1) 3,812 -- 3,049 -- 1,521 -- See's Candies ..... 27,411 23,884 24,526 14,235 12,212 6,914 Buffalo Evening News ..... 19,352 (1,215) 16,547 (724) 8,832 (226) Blue Chip Stamps(2) .....

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(15,104) (14,996) (13,844) (12,977) (7,346) (6,951) Special GEICO Distribution 21,000 -- 21,000 -- 19,551 -- Shareholder-Designated Contributions ..... (3,066) (891) (3,066) (891) (1,656) (481) Amortization of Goodwill ..

1999 letter

At General Re, we are raising rates and, if there is no mega-catastrophe in 2000, the company' s underwriting loss should fall considerably. It takes some time, however, for the full effect of rate increases to kick in, and General Re is therefore likely to have another unsatisfactory underwriting year. 5 You should be aware that one item regularly working to widen the amount by which intrinsic value exceeds book value is the annual charge against income we take for amortization of goodwill — an amount now running about $500 million. This charge reduces the amount of goodwill we show as an asset and likewise the amount that is included in our book value. This is an accounting matter having nothing to do with true economic goodwill, which increases in most years.

But even if economic goodwill were to remain constant, the annual amortization charge would persistently widen the gap between intrinsic value and book value. Though we can't give you a precise figure for Berkshire's intrinsic value, or even an approximation, Charlie and I can assure you that it far exceeds our $57.8 billion book value.

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When a company is acquired, generally accepted accounting principles ("GAAP") currently condone two ver y different ways of recording the transaction: "purchase" and "pooling." In a pooling, stock must be the currency; in a purchase, payment can be made in either cash or stock. Whatever the currency, managements usually detest purchase accounting because it almost always requires that a "goodwill" account be established and subsequently written off — a process that saddles earnings with a large annual charge that normally persists for decades. In contrast, pooling avoids a goodwill account, which is why managements love it. Now, the Financial Accounting Standards Board ("FASB") has proposed an end to pooling, and many CEOs are girding for battle.

It will be an important fight, so we'll venture some opinions. To begin with, we agree with the many managers who argue that goodwill amortization charges are usually spurious. You'll find my thinking about this in the appendix to our 1983 annual report, which is available on our website, and in the Owner's Manual on pages 55 - 62.

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The annual charges for these expenses can't be exactly measured, but the necessity for estimating them is obvious. In contrast, economic goodwill does not, in many cases, diminish. Indeed, in a great many instances — perhaps most — it actually grows in value over time. In character, economic goodwill is much like land: The value of both assets is sure to fluctuate, but the direction in which value is going to go is in no way ordained.

At See's, for example, economic goodwill has grown, in an irregular but very substantial manner, for 78 years. And, if we run the business right, growth of that kind will probably continue for at least another 78 years. To escape from the fiction of goodwill charges, managers embrace the fiction of pooling. This accountin g convention is grounded in the poetic notion that when two rivers merge their streams become indistinguishable.

Under this concept, a company that has been merged into a larger enterprise has not been "purchased" (even though it will often hav e received a large "sell-out" premium). Consequently, no goodwill is created, and those pesky subsequen t charges to earnings are eliminated. Instead, the accounting for the ongoing entity is handled as if the businesses had forever been one unit.

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Yes, there are some true "mergers of equals," but they are few and far between.

2015 letter

The carrying value of the "losers" we own is written down, but "winners" are never revalued upwards. We've had experience with both outcomes: I've made some dumb purchases, and the amount I paid for the economic goodwill of those companies was later written off, a move that reduced Berkshire's book value. We've also had some winners – a few of them very big – but have not written those up by a penny.

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The two types of liabilities, however, are treated as equals under GAAP. A partial offset to this overstated liability is a $15.5 billion "goodwill" asset that we incurred in buying our insurance companies and that increases book value. In very large part, this goodwill represents the price we paid for the float-generating capabilities of our insurance operations. The cost of the goodwill, however, has no bearing on its true value.

For example, if an insurance company sustains large and prolonged underwriting losses, any goodwill asset carried on the books should be deemed valueless, whatever its original cost. Fortunately, that does not describe Berkshire. Charlie and I believe the true economic value of our insurance goodwill – what we would happily pay for float of similar quality were we to purchase an insurance operation possessing it – to be far in excess of its historic carrying value. Indeed, almost the entire $15.5 billion we carry for goodwill in our insurance business was already on our books in 2000.

Yet we subsequently tripled our float.

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Let's look, though, at a summary balance sheet and earnings statement for the entire group. Balance Sheet 12/31/15 (in millions) Assets Liabilities and Equity Cash and equivalents ..... $ 6,807 Notes payable ..... $ 2,135 Accounts and notes receivable ..... 8,886 Other current liabilities ..... 10,565 Inventory ..... 11,916 Total current liabilities ..... 12,700 Other current assets ..... 9 7 0 Total current assets ..... 28,579 Deferred taxes ..... 3,649 Goodwill and other intangibles ..... 30,289 Term debt and other liabilities ..... 4,767 Fixed assets ..... 15,161 Non-controlling interests ..... 5 2 1 Other assets ..... 4,445 Berkshire equity ..... 56,837 $ 78,474 $ 78,474 Earnings Statement (in millions) 2015 2014 2013* Revenues ..... $107,825 $ 97,689 $ 93,472 Operating expenses ..... 100,607 90,788 87,208 Interest expense ..... 1 0 3 1 0 9 1 0 4 Pre-tax earnings ..... 7,115 6,792 6,160 Income taxes and non-controlling interests ..... 2,432 2,324 2,283 Net earnings ..... $ 4,683 $ 4,468 $ 3,877 * Earnings for 2013 have been restated to exclude Marmon's leasing operations, which are now included in the Finance and Financial Products results. Our income and expense data conforming to GAAP is on page 38.

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They employed an average of $25.6 billion of net tangible assets during 2015 and, despite their holding large quantities of excess cash and using only token amounts of leverage, earned 18.4% after-tax on that capital. 16 Of course, a business with terrific economics can be a bad investment if it is bought at too high a price. We have paid substantial premiums to net tangible assets for most of our businesses, a cost that is reflected in the large figure we show for goodwill and other intangibles. Overall, however, we are getting a decent return on the capital we have deployed in this sector.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1983, 1999, 2015 (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.