Look-through earnings

Berkshire letters: 1990, 1991, 1992 · Difficulty: Advanced

Summary
Under GAAP, Berkshire reports only the dividends from companies it owns less than 20% of, so its share of their **retained earnings** never shows up in Berkshire's profit. **Look-through earnings** add that share back (less the tax that would be due if it were paid out) to show the economic earnings of everything Berkshire owns.

1990 letter

However, I want to emphasize that this four-category presentation does not fall within the purview of our auditors, who in no way bless it. "Look-Through" Earnings The term "earnings" has a precise ring to it. And when an earnings figure is accompanied by an unqualified auditor's certificate, a naive reader might think it comparable in certitude to pi, calculated to dozens of decimal places.

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That would be a less efficient scenario: Because of taxes we would pay on dividend income, we would not be able to increase our proportionate ownership to the degree that Coke can, acting for us. If this less efficient procedure were followed, however, Berkshire would report far greater "earnings." I believe the best way to think about our earnings is in terms of "look-through" results, calculated as follows: Take $250 million, which is roughly our share of the 1990 operating earnings retained by our investees; subtract $30 million, for the incremental taxes we would have owed had that $250 million been paid to us in dividends; and add the remainder, $220 million, to our reported operating earnings of $371 million. Thus our 1990 "look-through earnings" were about $590 million. As I mentioned last year, we hope to have look-through earnings grow about 15% annually.

In 1990 we substantially exceeded that rate but in 1991 we will fall far short of it. Our Gillette preferred has been called and we will convert it into common stock on April 1. This will reduce reported earnings by about $35 million annually and look-through earnings by a much smaller, but still significant, amount. Additionally, our media earnings - both direct and look-through - appear sure to decline.

Whatever the results, we will post you annually on how we are doing on a look-through basis. Non-Insurance Operations Take another look at the figures on page 51, which aggregate the earnings and balance sheets of our non-insurance operations.

1991 letter

(6,772) (5,824) (4,388) (3,801) Other ..... 77,399 58,310 47,896 35,782 ---------- ---------- ---------- ---------- Operating Earnings 400,508 482,477 315,753 370,745 Sales of Securities 192,478 33,989 124,155 23,348 Total Earnings - All Entities $ 592,986 $ 516,466 $ 439,908 $ 394,093 *Excludes interest expense of Scott Fetzer Financial Group and Mutual Savings & Loan. "Look-Through" Earnings We've previously discussed look-through earnings, which consist of: (1) the operating earnings reported in the previous section, plus; (2) the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. I've told you that over time look-through earnings must increase at about 15% annually if our intrinsic business value is to grow at that rate. Indeed, since present management took over in 1965, our look-through earnings have grown at almost the identical 23% rate of gain recorded for book value.

Last year, however, our look-through earnings did not grow at all but rather declined by 14%. To an extent, the decline was precipitated by two forces that I discussed in last year's report and that I warned you would have a negative effect on look-through earnings. First, I told you that our media earnings - both direct and look-through - were "sure to decline"

and they in fact did. The second force came into play on April 1, when the call of our Gillette preferred stock required us to convert it into common.

The after-tax earnings in 1990 from our preferred had been about $45 million, an amount somewhat higher than the combination in 1991 of three months of dividends on our preferred plus nine months of look-through earnings on the common. Two other outcomes that I did not foresee also hurt lookthrough earnings in 1991.

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Last year I said that such a result at Wells was "a low-level possibility - not a likelihood." Second, we recorded significantly lower - though still excellent - insurance profits. The following table shows you how we calculate look-through earnings, although I warn you that the figures are necessarily very rough. (The dividends paid to us by these investees have been included in the operating earnings itemized on page 6, mostly under "Insurance Group: Net Investment Income.") Berkshire's Share of Undistributed Berkshire's Approximate Operating Earnings Berkshire's Major Investees Ownership at Yearend (in millions) ---------- ---------- ---------- 1991 1990 1991 1990 ------ ------ -------- -------- Capital Cities/ABC Inc. ..... 18.1% 17.9% $ 61 $ 85 The Coca-Cola Company ..... 7.0% 7.0% 69 58 Federal Home Loan Mortgage Corp. 3.4%(1) 3.2%(1) 15 10 The Gillette Company ..... 11.0% --- 23(2) --- GEICO Corp. ..... 48.2% 46.1% 69 76 The Washington Post Company .... 14.6% 14.6% 10 18 Wells Fargo & Company ..... 9.6% 9.7% (17) 19(3) -------- -------- Berkshire's share of undistributed earnings of major investees $230 $266 Hypothetical tax on these undistributed investee earnings (30) (35) Reported operating earnings of Berkshire 316 371 -------- -------- Total look-through earnings of Berkshire $516 $602 ======== ======== (1) Net of minority interest at Wesco (2) For the nine months after Berkshire converted its preferred on April 1 (3) Calculated on average ownership for the year * * * * * * * * * * * * We also believe that investors can benefit by focusing on their own look-through earnings. To calculate these, they should determine the underlying earnings attributable to the shares they hold in their portfolio and total these.

1992 letter

Our goal is to give you all of the financial information that Charlie and I consider significant in making our own evaluation of Berkshire. "Look-Through" Earnings We've previously discussed look-through earnings, which consist of: (1) the operating earnings reported in the previous section, plus; (2) the retained operating earnings of major investees that, under GAAP accounting, are not reflected in our profits, less; (3) an allowance for the tax that would be paid by Berkshire if these retained earnings of investees had instead been distributed to us. Though no single figure can be perfect, we believe that the look-through number more accurately portrays the earnings of Berkshire than does the GAAP number. I've told you that over time look-through earnings must increase at about 15% annually if our intrinsic business value is to grow at that rate.

Our look-through earnings in 1992 were $604 million, and they will need to grow to more than $1.8 billion by the year 2000 if we are to meet that 15% goal. For us to get there, our operating subsidiaries and investees must deliver excellent performances, and we must exercise some skill in capital allocation as well.

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Indeed, we may not even come close to it. But it does guide our decisionmaking: When we allocate capital today, we are thinking about what will maximize look-through earnings in 2000. We do not, however, see this long-term focus as eliminating the need for us to achieve decent short-term results as well.

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(Or perhaps with the farm: Investors should understand that for certain companies, and even for some industries, there simply is no good long-term strategy.) Just as you should be suspicious of managers who pump up short-term earnings by accounting maneuvers, asset sales and the like, so also should you be suspicious of those managers who fail to deliver for extended periods and blame it on their long-term focus. (Even Alice, after listening to the Queen lecture her about "jam tomorrow," finally insisted, "It must come sometimes to jam today.") The following table shows you how we calculate look-through earnings, though I warn you that the figures are necessarily very rough.

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