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Buffett on the Stock Market

Mr. Buffett on the Stock Market

I'm amazed that no one seems to have caught a bunch of irregularities that Warren Buffett has in his presentation.

First off, Buffett always says that there is no stock market, only a market for stocks but in this presentation all we can earn is the market average. Wealth is not distributed that way, ever. Some get rich, some go broke and most muddle through.

The second error that Buffett makes is that he assumes that the only growth that exists is the profit that corporations report. This is also not true in real life. Corporations replace plant and equipment through depreciation and amortization but when they use 'accelerated' depreciation, they are, in effect, depreciating more than the cost of the equipment and they are hiding some of the profit. Also, corporations take some money from revenues for research and development which is considered an expense but this research and development becomes additional assets over time. So the corporate base is actually growing a lot faster than the reported earnings indicate. Stock valuations are not based on earnings but on cash flow and corporations have a way of creating cash flow that is not reported as earnings.

Buffett uses automobiles and airplanes to "prove" that technologies that change the world don't make money for investors. This is a bunch of puppy cock. The car industry is not merely the 3 or the 3000 makers of cars. Any product, to be viable according to Geoffrey Moore, has to be a "whole product." The whole automobile product includes roads, gas stations, oil companies, mechanics, driving schools, street lights, steel, upholstery, garages and car washes to name a few. Maybe the 2997 other car maker didn't do too well but Henry Ford sure prospered. The big fortunes were made in oil, in gasoline, and Buffett conveniently ignores this industry which is part and parcel of the automobile industry. Buffett owns Gillette and he know it's not the razors but the blades. It's not the cars but the consumables like gasoline and oil. Rockefeller started his business selling lamp oil, kerosene, and when Edison invented the light bulb he was in trouble. In the early days of oil, kerosene was the useful product and gasoline was a dangerous byproduct that the oil companies did their damnedest to get rid of. On occasion they would dump it in rivers which would catch fire! The automobile came to rescue Rockefeller and converted gasoline into a useful product while kerosene was made obsolete by electricity and light bulbs. Now, the oil industry needs seismographs, derricks, prospectors....

Last but very interesting, the capital structure of corporations includes stocks and bonds. The interest that bonds pay are considered an expense and reduce the reported profit. But the bond holder considers the interest he receives as a return on capital just like the stock holder considers dividends and stock appreciation as return on capital. Accounting calls interest an expense but it calls the excess income over expenses "profit." The only real difference is the degree of risk that the investor took. Here is another case where accounting is confusing the issue. Then there is that hybrid, the preferred stock that pays interest which in the case of bonds is considered an expense but in the case of preferred shares is considered a payout of earnings. How is one interest different from the other? (I know the answer but I'll let you figure it out.)

Accounting can tell as many lies as statistics can. I sometimes wonder why accountants don't have long noses like Pinnoccio.

Denny
"Demand creates queues. Supply gets rid of them."
Software Times

On 6/26/01 12:19:55 AM, GeneP wrote:

<<Accounting can tell as many lies as statistics can. I sometimes wonder why accountants don't have long noses like Pinocchio.>>

Actually accounting can tell many stories, and stories within stories. While compliance with the myriad of GAAP (conceptually based on historical costs) is a major factor in conveying less than the most relevant picture, I expect these stories are some more consistent than the stories many analysts weave.

Increasingly users of financial information (management, creditors, stockholders, etc.) are relying on a hodge podge of data more than the published financials. Ultimately the primary benefit of today's certified audit may be for the litigator's lawsuits.

BTW, though I often crticize GAAP and the notion of "independent" audits ... I don't actually have a solution to the problem.

C. Eugene Prescott, CPA (NC)

http://www.taxtechcpa.com

On 6/26/01 9:50:42 AM, Denny wrote:

Gene:

Accounting was designed to keep track of the comings and goings of merchants and, for them, in a non inflationary world, it works perfectly. Merchants don't 'produce' anything, they don't transform raw materials into finished products like industrialists do. Merchants' profits come strictly from the differential between cost and sales price. For merchants in a non inflationary world, Assets and Liabilities and Income and Expense, are enough to keep track of their business.

Inflation, if not taken into account, is the first factor that skews accounts. In the seventies there was a movement afoot to change GAAP to include the effect of inflation. In Venezuela, for example, the central bank each month announces the 'IPC' (consumer price index). When we declare our taxes, we may adjust the historical cost of most things according to the IPC thereby eliminating inflation induced bracket creep in our income tax. In Brazil they index the bank deposits to protect savings. Indexing those things that have a liquid market, such as stocks and bonds, is easy, just look in the paper for the current quote. On the other hand, indexing plant and property is a lot more difficult but using the CPI or the PPI would be a good start.

Stock options really throw a monkey wrench into the accounting gears. Through stock options workers get their reward but the reward does not appear in the accounts as a cost. The only way for stock holders to measure their effect is by calculating the dilution of the stock value. Maybe the way to account for stock options is to charge the payroll (expense) account with the differential between the exercise price and the stock market price of the shares, after all, the shares were 'sold' by the company treasury at a loss.

A most difficult problem deals the real 'good will.' The original meaning of good will was the additional value that businesses gained because they earned the 'good will' of their customers through good and friendly service. Maybe this real good will should be ignored until a business is sold because there is no way to objectively measure it.

I would ask you to consider how manufacturing is different from commerce in its ability to produce new and valuable things (commerce just moves things around creating a benefit by their new, improved, convenient location and size). Should R&D be expensed or capitalized? The work done by the R&D team can be measured and expensed. But how about the new products and ideas that it creates? In manufacturing, you create an asset and charge a cost account. In R&D you also charge the cost account but you don't create the corresponding asset, you debit the loss account instead.

Manufacturing	**Debit**	**Credit**
Inventory	1,000	
Labor		400
Materials		400
Overhead		200
Total	1,000	1,000
Sales (I omitted a bunch of intermediate steps)	**Debit**	**Credit**
Cash	1,200	
Inventory		1000
Profit (Loss)		200
Total	1,200	1,200
R&D	**Debit**	**Credit**
Profit (Loss)	1,000	
Labor		600
Materials		200
Overhead		200
Total	1,000	1,000

Maybe the proper way to handle it is to create an 'intangible R ' asset account and amortize it over a number of years, after all, how is the knowledge to build a product so different from the machines needed to build the product? Both cost you money!
Just some thoughts to ponder...

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>Denny,

You, and others wondering about GAAP alternatives, might want to spend some time at:

http://home.sprintmail.com/~humphreynash/index.htm

This is the site of Humphrey H. Nash, PhD, FSA, who several years ago embarked on a one-man crusade to reform accounting. A "minor" problem that Nash tends to overlook entirely is how we are going to "account" for entities whose stocks do not trade on public markets. Many of his "value-added" notions would be problematic for small business compliance. It would be very interesting to see "comparative" results between Nash's proposals (developed in the mid to late '90s) and GAAP results for same entities in 1999, 2000, 2001. Nash has had difficulty gaining a "listening" audience among influential CPAs, perhaps because he is not one :-)

Actually interested novices can learn a lot about GAAP the FASB, and other methods of accounting from reading Nash (he is not shy in criticizing the FASB and the AICPA.)

C. Eugene Prescott, CPA (NC)

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Gene:

Thanks for the link. I don't think I want an 'accounting' that is really a 'guesstimating' even if it is based on discounted cash flows because I'm the only one qualified to pick the discount rate for my portfolio. For example, Buffett uses the 30 year gov bond rate and he adds no additional risk premium because he figures that the companies that he picks don't have added risk factors -- he weeded those companies out in his selection process.

I like the historic accounting principle if we could get it to include everything that is material (stock options) and if certain historic costs could be brought up to date, for example, replacement value and not historic value for depreciation and current market value for liquid investments (stocks and bonds).

A major improvement would happen if companies were allowed to keep two sets of books, one for Uncle Sam and the other for shareholders. The one for Uncle Sam would only deal with taxes while the other one would deal with real reality!

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Denny,

My you are a quick reader :-) .... it took me several days to read through Nash's stuff. But you are getting close to the issue ... the inherent risk in estimating anything. When we pick a discount rate and "win" we feel differently about other measurement schemes than when we pick a rate and "lose."

Actually US companies have long kept two sets of books .... a vast difference exists between GAAP and the IRC now. Granted these differences are reconciled on the return (what tax professionals call M1 and M2 items) and thereby can serve as a "red flag" ... there are routinely huge differences between "taxable income" and "economic income" now. Take a look at the insurance industry for rather dramatic examples. The problem is that one system deals with taxes and the other deals with another set of rules that may or may not approximate reality. That "may or may not" seems to apply to any set of rules that involve estimates or historical costs.

I'll bet this thread will soon have 10K reads! :-)

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Gene:

>>>My you are a quick reader :-)

Not really, I just stopped after reading the following in the second paragraph:

Basically, the AFTF value is the present value of all expected future net cash flows discounted at the market cost of capital. *The market cost of capital is the yield rate the shareholders require before they will buy the company's stock.*

This is a RED flag. Accounting is supposed to set out the facts, and not to pass judgment, that's reserved for management and stockholders to do. Notice that in my proposals above, there are no value judgments by the accountants, historical price would be replaced by current price if such a current price were available from a non-biased source, for example, the stock market. My other proposals would include in the accounts stuff that is currently excluded from the books such as the real value of stock options when exercised.

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Actually one of Nash's basic notions is that CPAs will ONLY be attesting to clearly computable facts ... and that others (actuaries and /or engineers, called modelers, for instance) would be responsbile for more. He also crtiques the AICPA's recent "visioning" process, does away with GAAP and FASB.

As far as I know, he has not obtained any "traction" with the AICPA or FASB managment. But he has performed the most exhaustive, critical analysis of current accounting shortcomings of which I'm aware.

While there will be significant issues with anything changing that radically, it is likely any attempt at radical change requires being aware of Nash's precepts. Sometimes fixing things can be hard work :-)

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