BERKSHIRE HATHAWAY INC.

1986

ANNUAL REPORT TO THE STOCKHOLDERS

BERKSHIRE HATHAWAY INC.
Selected Financial Data
at Five-Year Intervals
(dollars in thousands — except per share amounts)

	1966	1971	1976	1981	1986
Revenues of consolidated companies:					
Sales and service revenues	$ 49,372	$ 26,011	$ 47,174	$ 312,105	$1,225,290
Insurance premiums earned	—	60,867	80,780	159,013	823,884
Interest and dividend income	$ —	5,106	10,820	54,035	$ 118,429
Earnings data:					
Before realized investment gain	$ 2,763	$ 6,941	$ 16,073	$ 39,723	$ 131,464
Realized investment gain (loss)	—	745	6,762	22,881	150,897
Net earnings	$ 2,763	$ 7,686	22,835	$ 62,604	$ 282,361
Year-end data:					
Total assets	$ 32,896	$159,102	$283,041	$1,199,837	$4,441,655
Term debt and other borrowings ...	—	9,641	24,987	130,192	94,923
Minority shareholders' interest	—	—	—	81,762	43,289
Stockholders' equity — total	29,495	56,169	115,293	519,463	2,377,797
Shares of common stock outstanding — in thousands	1,018	980	973	987	1,147
Shareholders' equity per outstanding share	$ 28.97	$ 57.32	$ 118.49	$ 526.30	$ 2,073.06

Data is shown as previously reported, except that data for 1971 reflects insurance subsidiaries on a consolidated basis consistent with the presentation practice for later years. The 1986 fiscal year ended on December 31. The 1966 fiscal year ended on October 1. Other years ended on the Saturday nearest December 31.

BERKSHIRE HATHAWAY INC.

1986 ANNUAL REPORT

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A compilation of letters taken from Berkshire Hathaway Inc. Annual Reports for the years from 1979 to 1985 is available upon request. Direct your request to the Company at 1440 Kiewit Plaza, Omaha, Nebraska 68131.

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BERKSHIRE HATHAWAY INC.
Business Activities
December 31, 1986

Berkshire Hathaway Inc. is a holding company owning subsidiaries engaged in a number of diverse business activities. The most important of these is the property and casualty insurance business conducted on both a direct and reinsurance basis through a number of subsidiaries collectively referred to in this report as the *Berkshire Hathaway Insurance Group*. Business activities conducted by other Berkshire subsidieries include publication and distribution of encyclopedias and related educational and instructional material (*World Book* and *Childcraft* products), manufacture and marketing of vacuum cleaners and related accessories (sold principally under the *Kirby* name), manufacture and sale of boxed chocolates and other confectionery products (*See's Candies*), publication of a daily and Sunday newspaper in upstate New York (the *Buffalo News*), retailing of home furnishings (the *Nebraska Furniture Mart*) and manufacture and distribution of uniforms (*The Fechheimer Brothers Company*).

Wesco Financial Corporation is an 80.1% owned subsidiary of the Company. Wesco's common stock that is not owned by Berkshire is held by public shareholders. Wesco stock is listed on the American Stock Exchange and the Pacific Stock Exchange. Wesco's principal businesses are conducted by its wholly-owned subsidiaries. One such subsidiary is engaged in the property and casualty insurance business and its results are included in this report with those of the Berkshire Hathaway Insurance Group. Wesco also has investments in real estate and owns a California chartered savings and loan company (*Mutual Savings and Loan Association*, Pasadena, California) and a steel service center business.

The various member companies of the Berkshire Hathaway Insurance Group, headed by National Indemnity Company in Omaha, Nebraska, provide on a direct basis to primarily commercial accounts multiple lines of principally casualty insurance coverages. Marketing focus for the Group's direct business is upon specific product/market segments. For example, liability coverages for truck and bus operators is and long has been such a focus of National Indemnity. Marketing intermediaries employed include general and independent agents as well as wholesale and retail insurance and reinsurance brokers. The Group has, since September 1, 1985, participated heavily as a quota share reinsurer of other major insurance companies. Financial strength that is significantly higher than normal for the property/casualty insurance industry is a feature and marketing aid of Berkshire Hathaway Insurance Group members.

Significant amounts of investment income are generated by investment activities that center in the Insurance Group. Group members' investable funds derive from the extensive amount of capital funds committed to the operations as well as from policyholder funds represented by unearned premiums and loss reserves.

Very significant Berkshire investments include ownership of approximately 41% of the outstanding capital stock of GEICO Corporation, and of approximately 18% of the capital stock of Capital Cities/ABC, Inc.

Operating decisions for the various Berkshire businesses are made by managers of the business units. Investment decisions and all other capital allocation decisions are made for the businesses by Warren E. Buffett, in consultation with Charles T. Munger. Mr. Buffett is Chairman and Mr. Munger is Vice Chairman of Berkshire's Board of Directors. Additionally, Mr. Munger is Chairman of Wesco's Board of Directors.

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BERKSHIRE HATHAWAY INC.

OWNER-RELATED BUSINESS PRINCIPLES

Reproduced from 1983 Annual Report

- Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. (Because of the size of our shareholdings we also are, for better or worse, controlling partners.) We do not view the company itself as the ultimate owner of our business assets but, instead, view the company as a conduit through which our shareholders own the assets.

- In line with this owner-orientation, our directors are all major shareholders of Berkshire Hathaway. In the case of at least four of the five, over 50% of family net worth is represented by holdings of Berkshire. We eat our own cooking.

- Our long-term economic goal (subject to some qualifications mentioned later) is to maximize the average annual rate of gain in intrinsic business value on a per-share basis. We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress. We are certain that the rate of per-share progress will diminish in the future — a greatly enlarged capital base will see to that. But we will be disappointed if our rate does not exceed that of the average large American corporation.

- Our preference would be to reach this goal by directly owning a diversified group of businesses that generate cash and consistently earn above-average returns on capital. Our second choice is to own parts of similar businesses, attained primarily through purchases of marketable common stocks by our insurance subsidiaries. The price and availability of businesses and the need for insurance capital determine any given year's capital allocation.

- Because of this two-pronged approach to business ownership and because of the limitations of conventional accounting, consolidated reported earnings may reveal relatively little about our true economic performance. Charlie and I, both as owners and managers, virtually ignore such consolidated numbers. However, we will also report to you the earnings of each major business we control, numbers we consider of great importance. These figures, along with other information we will supply about the individual businesses, should generally aid you in making judgments about them.

- Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase $2 of earnings that is not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable. This is precisely the choice that often faces us since entire businesses (whose earnings will be fully reportable) frequently sell for double the pro-rata price of small portions (whose earnings will be largely unreportable). In aggregate and over time, we expect the unreported earnings to be fully reflected in our intrinsic business value through capital gains.

- We rarely use much debt and, when we do, we attempt to structure it on a long-term fixed-rate basis. We will reject interesting opportunities rather than over-leverage our balance sheet. This conservatism has penalized our results but it is the only behavior that leaves us comfortable, considering our fiduciary obligations to policyholders, depositors, lenders and the many equity holders who have committed unusually large portions of their net worth to our care. (As one of the Indianapolis "500" winners said: "To finish first, you must first finish.")

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- A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. We will only do with your money what we would do with our own, weighing fully the values you can obtain by diversifying your own portfolios through direct purchases in the stock market.

- We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least $1 of market value for each $1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis. As our net worth grows, it is more difficult to use retained earnings wisely.

- We will issue common stock only when we receive as much in business value as we give. This rule applies to all forms of issuance — not only mergers or public stock offerings, but stock-for-debt swaps, stock options, and convertible securities as well. We will not sell small portions of your company — and that is what the issuance of shares amounts to — on a basis inconsistent with the value of the entire enterprise.

- You should be fully aware of one attitude Charlie and I share that hurts our financial performance: regardless of price, we have no interest at all in selling any good businesses that Berkshire owns, and are very reluctant to sell sub-par businesses as long as we expect them to generate at least some cash and as long as we feel good about their managers and labor relations. We hope not to repeat the capital-allocation mistakes that led us into such sub-par businesses. And we react with great caution to suggestions that our poor businesses can be restored to satisfactory profitability by major capital expenditures. (The projections will be dazzling — the advocates will be sincere — but, in the end, major additional investment in a terrible industry usually is about as rewarding as struggling in quicksand.) Nevertheless, gin rummy managerial behavior (discard your least promising business at each turn) is not our style. We would rather have our overall results penalized a bit than engage in it.

- We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less. Moreover, as a company with a major communications business, it would be inexcusable for us to apply lesser standards of accuracy, balance and incisiveness when reporting on ourselves than we would expect our news people to apply when reporting on others. We also believe candor benefits us as managers: the CEO who misleads others in public may eventually mislead himself in private.

- Despite our policy of candor, we will discuss our activities in marketable securities only to the extent legally required. Good investment ideas are rare, valuable and subject to competitive appropriation just as good product or business acquisition ideas are. Therefore, we normally will not talk about our investment ideas. This ban extends even to securities we have sold (because we may purchase them again) and to stocks we are incorrectly rumored to be buying. If we deny those reports but say "no comment" on other occasions, the no-comments become confirmation.

To the Shareholders of Berkshire Hathaway Inc.:

Our gain in net worth during 1986 was $492.5 million, or 26.1%. Over the last 22 years (that is, since present management took over), our per-share book value has grown from $19.46 to $2,073.06, or 23.3% compounded annually. Both the numerator and denominator are important in the per-share book value calculation: during the 22-year period our corporate net worth has increased 10,600% while shares outstanding have increased less than 1%.

In past reports I have noted that book value at most companies differs widely from intrinsic business value -- the number that really counts for owners. In our own case, however, book value has served for more than a decade as a reasonable if somewhat conservative proxy for business value. That is, our business value has moderately exceeded our book value, with the ratio between the two remaining fairly steady.

The good news is that in 1986 our percentage gain in business value probably exceeded the book-value gain. I say "probably" because business value is a soft number: in our own case, two equally well-informed observers might make judgments more than 10% apart.

A large measure of our improvement in business value relative to book value reflects the outstanding performance of key managers at our major operating businesses. These managers — the Blumkins, Mike Goldberg, the Heldmans, Chuck Huggins, Stan Lipsey, and Ralph Schey — have over the years improved the earnings of their businesses dramatically while, except in the case of insurance, utilizing little additional capital. This accomplishment builds economic value, or "Goodwill," that does not show up in the net worth figure on our balance sheet, nor in our per-share book value. In 1986 this unrecorded gain was substantial.

So much for the good news. The bad news is that my performance did not match that of our managers. While they were doing a superb job in running our businesses, I was unable to skillfully deploy much of the capital they generated.

Charlie Munger, our Vice Chairman, and I really have only two jobs. One is to attract and keep outstanding managers to run our various operations. This hasn't been all that difficult. Usually the managers came with the companies we bought, having demonstrated their talents throughout careers that spanned a wide variety of business circumstances. They were managerial stars long before they knew us, and our main contribution has been to not get in their way. This approach seems elementary: if my job were to manage a golf team — and if Jack Nicklaus or Arnold Palmer were willing to play for me — neither would get a lot of directives from me about how to swing.

Some of our key managers are independently wealthy (we hope they all become so), but that poses no threat to their continued interest: they work because they love what they do and relish the thrill of outstanding performance. They unfailingly think like owners (the highest compliment we can pay a manager) and find all aspects of their business absorbing.

(Our prototype for occupational fervor is the Catholic tailor who used his small savings of many years to finance a pilgrimage to the Vatican. When he returned, his parish held a special meeting to get his first-hand account of the Pope. "Tell us," said the eager faithful, "just what sort of fellow is he?" Our hero wasted no words: "He's a forty-four, medium.")

Charlie and I know that the right players will make almost any team manager look good. We subscribe to the philosophy of Ogilvy & Mather's founding genius, David Ogilvy: "If each of us hires people who are smaller than we are, we shall become a company of dwarfs. But, if each of us hires people who are bigger than we are, we shall become a company of giants."

A by-product of our managerial style is the ability it gives us to easily expand Berkshire's activities. We've read management treatises that specify exactly how many people should report to any one executive, but they make little sense to us. When you have able managers of high character running businesses about which they are passionate, you can have a dozen or more reporting to you and still

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have time for an afternoon nap. Conversely, if you have even one person reporting to you who is deceitful, inept or uninterested, you will find yourself with more than you can handle. Charlie and I could work with double the number of managers we now have, so long as they had the rare qualities of the present ones.

We intend to continue our practice of working only with people whom we like and admire. This policy not only maximizes our chances for good results, it also ensures us an extraordinarily good time. On the other hand, working with people who cause your stomach to churn seems much like marrying for money — probably a bad idea under any circumstances, but absolute madness if you are already rich.

The second job Charlie and I must handle is the allocation of capital, which at Berkshire is a considerably more important challenge than at most companies. Three factors make that so: we earn more money than average; we retain all that we earn; and, we are fortunate to have operations that, for the most part, require little incremental capital to remain competitive and to grow. Obviously, the future results of a business earning 23% annually and retaining it all are far more affected by today's capital allocations than are the results of a business earning 10% and distributing half of that to shareholders. If our retained earnings — and those of our major investees, GEICO and Capital Cities/ABC, Inc. — are employed in an unproductive manner, the economics of Berkshire will deteriorate very quickly. In a company adding only, say, 5% to net worth annually, capital-allocation decisions, though still important, will change the company's economics far more slowly.

Capital allocation at Berkshire was tough work in 1986. We did make one business acquisition — The Fechheimer Bros. Company, which we will discuss in a later section. Fechheimer is a company with excellent economics, run by exactly the kind of people with whom we enjoy being associated. But it is relatively small, utilizing only about 2% of Berkshire's net worth.

Meanwhile, we had no new ideas in the marketable equities field, an area in which once, only a few years ago, we could readily employ large sums in outstanding businesses at very reasonable prices. So our main capital allocation moves in 1986 were to pay off debt and stockpile funds. Neither is a fate worse than death, but they do not inspire us to do handsprings either. If Charlie and I were to draw blanks for a few years in our capital-allocation endeavors, Berkshire's rate of growth would slow significantly.

We will continue to look for operating businesses that meet our tests and, with luck, will acquire such a business every couple of years. But an acquisition will have to be large if it is to help our performance materially. Under current stock market conditions, we have little hope of finding equities to buy for our insurance companies. Markets will change significantly — you can be sure of that — and some day we will again get our turn at bat. However, we haven't the faintest idea when that might happen.

It can't be said too often (although I'm sure you feel I've tried) that, even under favorable conditions, our returns are certain to drop substantially because of our enlarged size. We have told you that we hope to average a return of 15% on equity and we maintain that hope, despite some negative tax-law changes described in a later section of this report. If we are to achieve this rate of return, our net worth must increase $7.2 billion in the next ten years. A gain of that magnitude will be possible only if, before too long, we come up with a few very big (and good) ideas. Charlie and I can't promise results, but we do promise you that we will keep our efforts focused on our goals.

Sources of Reported [illegible]

The table on the next page shows the major sources of Berkshire's reported earnings. This table differs in several ways from the one presented last year. We have added four new lines of business because of the Scott Fetzer and Fechheimer acquisitions. In the case of Scott Fetzer, the two major units acquired were World Book and Kirby, and each is presented separately. Fourteen other businesses of Scott Fetzer are aggregated in Scott Fetzer — Diversified Manufacturing. SF Financial Group, a credit company holding both World Book and Kirby receivables, is included in "Other." This year, because Berkshire is so much larger, we also have eliminated separate reporting for several of our smaller businesses.

In the table, amortization of Goodwill is not charged against the specific businesses but, for reasons outlined in the Appendix to my letter in the 1983 Annual Report, is aggregated as a separate item. (A Compendium of earlier letters, including the Goodwill discussion, is available upon request.) Both the Scott Fetzer and Fechheimer acquisitions created accounting Goodwill, which is why the amortization charge for Goodwill increased in 1986.

Additionally, the Scott Fetzer acquisition required other major purchase-price accounting adjustments, as prescribed by generally accepted accounting principles (GAAP). The GAAP figures, of course, are the ones used in our consolidated financial statements. But, in our view, the GAAP figures are not necessarily the most useful ones for investors or managers. Therefore, the figures shown for specific operating units are earnings before purchase-price adjustments are taken into account. In effect, these are the earnings that would have been reported by the businesses if we had not purchased them.

A discussion of our reasons for preferring this form of presentation is in the Appendix to this letter. This Appendix will never substitute for a steamy novel and definitely is not required reading. However, I know that among our 6,000 shareholders there are those who are thrilled by my essays on accounting — and I hope that both of you enjoy the Appendix.

In the Business Segment Data on pages 41-43 and in the Management's Discussion section on pages 45-49, you will find much additional information about our businesses. I urge you to read those sections, as well as Charlie Munger's letter to Wesco shareholders, describing the various businesses of that subsidiary, which starts on page 50.

	(000s omitted)			
	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1986	*1985*	*1986*	*1985*
Operating Earnings:				
Insurance Group:				
Underwriting	$(55,844)	$(44,230)	$(29,864)	$(23,569)
Net Investment Income	107,143	95,217	96,440	79,716
Buffalo News	34,736	29,921	16,918	14,580
Fechheimer (Acquired 6/3/86)	8,400	—	3,792	—
Kirby	20,218	—	10,508	—
Nebraska Furniture Mart	17,685	12,686	7,192	5,181
Scott Fetzer — Diversified Mfg.	25,358	—	13,354	—
See's Candies	30,347	28,989	15,176	14,558
Wesco — other than insurance	5,542	16,018	5,550	9,684
World Book	21,978	—	11,670	—
Amortization of Goodwill	(2,555)	(1,475)	(2,555)	(1,475)
Other purchase-price accounting charges	(10,033)	—	(11,031)	—
Interest on Debt and Pre-Payment penalty	(23,891)	(14,415)	(12,213)	(7,288)
Shareholder-Designated Contributions	(3,997)	(4,006)	(2,158)	(2,164)
Other	20,770	6,744	8,685	3,725
Operating Earnings	195,857	125,449	131,464	92,948
Special General Foods Distribution	—	4,127	—	3,779
Special Washington Post Distribution	—	14,877	—	13,851
Sales of securities	216,242	468,903	150,897	325,237
Total Earnings — all entities	$412,090	$613,356	$282,361	$435,815

As you can see, operating earnings substantially improved during 1986. Some of the improvement came from the insurance operation, whose results I will discuss in a later section. Fechheimer also will be discussed separately. Our other major businesses performed as follows:

- Operating results at The Buffalo News continue to reflect a truly superb managerial job by Stan Lipsey. For the third year in a row, man-hours worked fell significantly and other costs were closely controlled. Consequently, our operating margins improved materially in 1986, even though our advertising rate increases were well below those of most major newspapers.

Our cost-control efforts have in no way reduced our commitment to news. We continue to deliver a 50% "news hole" (the portion of the total space in the paper devoted to news), a higher percentage, we believe, than exists at any dominant newspaper in this country of our size or larger.

The average news hole at papers comparable to the News is about 40%. The difference between 40% and 50% is more important than it might first seem: a paper with 30 pages of ads and a 40% news hole delivers 20 pages of news a day, whereas our paper matches 30 pages of ads with 30 pages of news. Therefore, given ad pages equal in number, we end up delivering our readers no less than 50% more news.

We believe this heavy commitment to news is one of the reasons The Buffalo News has the highest weekday penetration rate (the percentage of households in the paper's primary marketing area purchasing it each day) among any of the top 50 papers in the country. Our Sunday penetration, where we are also number one, is even more impressive. Ten years ago, the only Sunday paper serving Buffalo (the Courier-Express) had circulation of 271,000 and a penetration ratio of about 63%. The Courier-Express had served the area for many decades and its penetration ratio — which was similar to those existing in many metropolitan markets — was thought to be a "natural" one, accurately reflecting the local citizenry's appetite for a Sunday product.

Our Sunday paper was started in late 1977. It now has a penetration ratio of 83% and sells about 100,000 copies more each Sunday than did the Courier-Express ten years ago — even though population in our market area has declined during the decade. In recent history, no other city that has long had a local Sunday paper has experienced a penetration gain anywhere close to Buffalo's.

Despite our exceptional market acceptance, our operating margins almost certainly have peaked. A major newsprint price increase took effect at the end of 1986, and our advertising rate increases in 1987 will again be moderate compared to those of the industry. However, even if margins should materially shrink, we would not reduce our news-hole ratio.

As I write this, it has been exactly ten years since we purchased The News. The financial rewards it has brought us have far exceeded our expectations and so, too, have the non-financial rewards. Our respect for the News — high when we bought it — has grown consistently ever since the purchase, as has our respect and admiration for Murray Light, the editor who turns out the product that receives such extraordinary community acceptance. The efforts of Murray and Stan, which were crucial to the News during its dark days of financial reversals and litigation, have not in the least been lessened by prosperity. Charlie and I are grateful to them.

- The amazing Blumkins continue to perform business miracles at Nebraska Furniture Mart. Competitors come and go (mostly go), but Mrs. B. and her progeny roll on. In 1986 net sales increased 10.2% to $132 million. Ten years ago sales were $44 million and, even then, NFM appeared to be doing just about all of the business available in the Greater Omaha Area. Given NFM's remarkable dominance, Omaha's slow growth in population and the modest inflation rates that have applied to the goods NFM sells, how can this operation continue to rack up such large sales gains? The only logical explanation is that the marketing territory of NFM's one-and-only store continues to widen because of its ever-growing reputation for rock-bottom everyday prices and the broadest of selections. In preparation for further gains, NFM is expanding the capacity of its warehouse, located a few hundred yards from the store, by about one-third.

Mrs. B, Chairman of Nebraska Furniture Mart, continues at age 93 to outsell and out-hustle any manager I've ever seen. She's at the store seven days a week, from opening to close. Competing with her represents a triumph of courage over judgment.

It's easy to overlook what I consider to be the critical lesson of the Mrs. B saga: at 93, Omaha-based Board Chairmen have yet to reach their peak. Please file this fact away to consult before you mark your ballot at the 2024 annual meeting of Berkshire.

- At See's, sales trends improved somewhat from those of recent years. Total pounds sold rose about 2%. (For you chocaholics who like to fantasize, one statistic: we sell over 12,000 tons annually.) Same-store sales, measured in pounds, were virtually unchanged. In the previous six years, same-store poundage fell, and we gained or maintained poundage volume only by adding stores. But a particularly strong Christmas season in 1986 stemmed the decline. By stabilizing same-store volume and making a major effort to control costs, See's was able to maintain its excellent profit margin in 1986 though it put through only minimal price increases. We have Chuck Huggins, our long-time manager at See's, to thank for this significant achievement.

See's has a one-of-a-kind product "personality" produced by a combination of its candy's delicious taste and moderate price, the company's total control of the distribution process, and the exceptional service provided by store employees. Chuck rightfully measures his success by the satisfaction of our customers, and his attitude permeates the organization. Few major retailing companies have been able to sustain such a customer-oriented spirit, and we owe Chuck a great deal for keeping it alive and well at See's.

See's profits should stay at about their present level. We will continue to increase prices very modestly, merely matching prospective cost increases.

- World Book is the largest of 17 Scott Fetzer operations that joined Berkshire at the beginning of 1986. Last year I reported to you enthusiastically about the businesses of Scott Fetzer and about Ralph Schey, its manager. A year's experience has added to my enthusiasm for both. Ralph is a superb businessman and a straight shooter. He also brings exceptional versatility and energy to his job: despite the wide array of businesses that he manages, he is on top of the operations, opportunities and problems of each. And, like our other managers, Ralph is a real pleasure to work with. Our good fortune continues.

World Book's unit volume increased for the fourth consecutive year, with encyclopedia sales up 7% over 1985 and 45% over 1982. Childcraft's unit sales also grew significantly.

World Book continues to dominate the U.S. direct-sales encyclopedia market — and for good reasons. Extraordinarily well-edited and priced at under 5¢ per page, these books are a bargain for youngster and adult alike. You may find one editing technique interesting: World Book ranks over 44,000 words by difficulty. Longer entries in the encyclopedia include only the most easily comprehended words in the opening sections, with the difficulty of the material gradually escalating as the exposition proceeds. As a result, youngsters can easily and profitably read to the point at which subject matter gets too difficult, instead of immediately having to deal with a discussion that mixes up words requiring college-level comprehension with others of fourth-grade level.

Selling World Book is a calling. Over one-half of our active salespeople are teachers or former teachers, and another 5% have had experience as librarians. They correctly think of themselves as educators, and they do a terrific job. If you don't have a World Book set in your house, I recommend one.

- Kirby likewise recorded its fourth straight year of unit volume gains. Worldwide, unit sales grew 4% from 1985 and 33% from 1982. While the Kirby product is more expensive than most cleaners, it performs in a manner that leaves cheaper units far behind ("in the dust," so to speak). Many 30- and 40-year-old Kirby cleaners are still in active duty. If you want the best, you buy a Kirby.

Some companies that historically have had great success in direct sales have stumbled in recent years. Certainly the era of the working woman has created new challenges for direct sales organizations. So far, the record shows that both Kirby and World Book have responded most successfully.

The businesses described above, along with the insurance operation and Fechheimer, constitute our major business units. The brevity of our descriptions is in no way meant to diminish the importance of these busineses to us. All have been discussed in past annual reports and, because of the tendency of Berkshire owners to stay in the fold (about 98% of the stock at the end of each year is owned by people who were owners at the start of the year), we want to avoid undue repetition of basic facts. You can be sure that we will immediately report to you in detail if the underlying economics or competitive position of any of these businesses should materially change. In general, the businesses described in this section can be characterized as having very strong market positions, very high returns on capital employed, and the best of operating managements.

The Fechheimer Bros. Co.

Every year in Berkshire's annual report I include a description of the kind of business that we would like to buy. This "ad" paid off in 1986.

On January 15th of last year I received a letter from Bob Heldman of Cincinnati, a shareholder for many years and also Chairman of Fechheimer Bros. Until I read the letter, however, I did not know of either Bob or Fechheimer. Bob wrote that he ran a company that met our tests and suggested that we get together, which we did in Omaha after their results for 1985 were compiled.

He filled me in on a little history: Fechheimer, a uniform manufacturing and distribution business, began operations in 1842. Warren Heldman, Bob's father, became involved in the business in 1941 and his sons, Bob and George (now President), along with their sons, subsequently joined the company. Under the Heldmans' management, the business was highly successful.

In 1981 Fechheimer was sold to a group of venture capitalists in a leveraged buyout (an LBO), with management retaining an equity interest. The new company, as is the case with all LBOs, started with an exceptionally high debt/equity ratio. After the buyout, however, operations continued to be very successful. So by the start of last year debt had been paid down substantially and the value of the equity had increased dramatically. For a variety of reasons, the venture capitalists wished to sell and Bob, having dutifully read Berkshire's annual reports, thought of us.

Fechheimer is exactly the sort of business we like to buy. Its economic record is superb; its managers are talented, high-grade, and love what they do; and the Heldman family wanted to continue its financial interest in partnership with us. Therefore, we quickly purchased about 84% of the stock for a price that was based upon a $55 million valuation for the entire business.

The circumstances of this acquisition were similar to those prevailing in our purchase of Nebraska Furniture Mart: most of the shares were held by people who wished to employ funds elsewhere; family members who enjoyed running their business wanted to continue both as owners and managers; several generations of the family were active in the business, providing management for as far as the eye can see; and the managing family wanted a purchaser who would not re-sell, regardless of price, and who would let the business be run in the future as it had been in the past. Both Fechheimer and NFM were right for us, and we were right for them.

You may be amused to know that neither Charlie nor I have been to Cincinnati, headquarters for Fechheimer, to see their operation. (And, incidentally, it works both ways: Chuck Huggins, who has been running See's for 15 years, has never been to Omaha.) If our success were to depend upon insights we developed through plant inspections, Berkshire would be in big trouble. Rather, in considering an acquisition, we attempt to evaluate the economic characteristics of the business — its competitive strengths and weaknesses — and the quality of the people we will be joining. Fechheimer was a standout in both respects. In addition to Bob and George Heldman, who are in their mid-60s — spring chickens by our standards — there are three members of the next generation, Gary, Roger and Fred, to insure continuity.

As a prototype for acquisitions, Fechheimer has only one drawback: size. We hope our next acquisition is at least several times as large — but a carbon copy in all other respects. Our threshold for minimum annual after-tax earnings of potential acquisitions has been moved up to $10 million from the $5 million level that prevailed when Bob wrote to me.

Flushed with success, we repeat our ad. If you have a business that fits, call me or, preferably, write.

Here's what we're looking for:

(1) large purchases (at least $10 million of after-tax earnings),

(2) demonstrated consistent earning power (future projections are of little interest to us, nor are "turn-around" situations),

(3) businesses earning good returns on equity while employing little or no debt.

(4) management in place (we can't supply it),

(5) simple businesses (if there's lots of technology, we won't understand it),

(6) an offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer -- customarily within five minutes — as to whether we're interested. We prefer to buy for cash, but will consider issuing stock when we receive as much in intrinsic business value as we give. Indeed, following recent advances in the price of Berkshire stock, transactions involving stock issuance may be quite feasible. We invite potential sellers to check us out by contacting people with whom we have done business in the past. For the right business — and the right people — we can provide a good home.

On the other hand, we frequently get approached about acquisitions that don't come close to meeting our tests: new ventures, turn-arounds, auction-like sales, and the ever-popular (among brokers) "I'm-sure-something-will-work-out-if-you-people-get-to-know-each-other." None of these attracts us in the least.

* * *

Besides being interested in the purchases of entire businesses as described above, we are also interested in the negotiated purchase of large, but not controlling, blocks of stock, as in our Cap Cities purchase. Such purchases appeal to us only when we are very comfortable with both the economics of the business and the ability and integrity of the people running the operation. We prefer large transactions: in the unusual case we might do something as small as $50 million (or even smaller), but our preference is for commitments many times that size.

Insurance Operations

We present our usual table of industry figures, expanded this year to include data about incurred losses and the GNP inflation index. The contrast in 1986 between the growth in premiums and growth in incurred losses will show you why underwriting results for the year improved materially:

	Yearly Change in Premiums Written (%)	*Statutory Combined Ratio After Policyholder Dividends*	*Yearly Change in Incurred Losses (%)*	*Inflation Rate Measured by GNP Deflator (%)*
1981	3.8	106.0	6.5	9.7
1982	4.4	109.8	8.4	6.4
1983	4.6	112.0	6.8	3.9
1984	9.2	117.9	16.9	3.8
1985	22.1	116.5	16.1	3.3
1986 (Est.)	22.6	108.5	15.5	2.6

Source: Best's Insurance Management Reports

The combined ratio represents total insurance costs (losses incurred plus expenses) compared to revenue from premiums: a ratio below 100 indicates an underwriting profit, and one above 100 indicates a loss. When the investment income that an insurer earns from holding on to policyholders' funds ("the float") is taken into account, a combined ratio in the 107-112 range typically produces an overall breakeven result, exclusive of earnings on the funds provided by shareholders.

The math of the insurance business, encapsulated by the table, is not very complicated. In years when the industry's annual gain in revenues (premiums) pokes along at 4% or 5%, underwriting losses are sure to mount. This is not because auto accidents, fires, windstorms and the like are occurring more frequently, nor has it lately been the fault of general inflation. Today, social and judicial inflation are the major culprits; the cost of entering a courtroom has simply ballooned. Part of the jump in cost arises from skyrocketing verdicts, and part from the tendency of judges and juries to expand the coverage of insurance policies beyond that contemplated by the insurer when the policies were written. Seeing no let-up in either trend, we continue to believe that the industry's revenues must grow at close to 10% annually for it to just hold its own in terms of profitability, even though general inflation may be running only 2% - 4%.

In 1986, as noted, the industry's premium volume soared even faster than loss costs. Consequently, the underwriting loss of the industry fell dramatically. In last year's report we predicted this sharp improvement but also predicted that prosperity would be fleeting. Alas, this second prediction is already proving accurate. The rate of gain in the industry's premium volume has slowed significantly (from an estimated 27.1% in 1986's first quarter, to 23.5% in the second, to 21.8% in the third, to 18.7% in the fourth), and we expect further slowing in 1987. Indeed, the rate of gain may well fall below my 10% "equilibrium" figure by the third quarter.

Nevertheless, underwriting results in 1987, assuming they are not dragged down by a major natural catastrophe, will again improve materially because price increases are recognized in revenues on a lagged basis. In effect, the good news in earnings follows the good news in prices by six to twelve months. But the improving trend in earnings will probably end by late 1988 or early 1989. Thereafter the industry is likely to head south in a hurry.

Pricing behavior in the insurance industry continues to be exactly what can be expected in a commodity-type business. Only under shortage conditions are high profits achieved, and such conditions don't last long. When the profit sun begins to shine, long-established insurers shower investors with new shares in order to build capital. In addition, newly-formed insurers rush to sell shares at the advantageous prices available in the new-issue market (prices advantageous, that is, to the insiders promoting the company but rarely to the new shareholders). These moves guarantee future trouble: capacity soars, competitive juices flow, and prices fade.

It's interesting to observe insurance leaders beseech their colleagues to behave in a more "statesmanlike" manner when pricing policies. "Why," they ask, "can't we learn from history, even out the peaks and valleys, and consistently price to make reasonable profits?" What they wish, of course, is pricing that resembles, say, that of The Wall Street Journal, whose prices are ample to start with and rise consistently each year.

Such calls for improved behavior have all of the efficacy of those made by a Nebraska corn grower asking his fellow growers, worldwide, to market their corn with more statesmanship. What's needed is not more statesmen, but less corn. By raising large amounts of capital in the last two years, the insurance industry has, to continue our metaphor, vastly expanded its plantings of corn. The resulting increase in "crop" — i.e., the proliferation of insurance capacity — will have the same effect on prices and profits that surplus crops have had since time immemorial.

Our own insurance operation did well in 1986 and is also likely to do well in 1987. We have benefited significantly from industry conditions. But much of our prosperity arises from the efforts and ability of Mike Goldberg, manager of all insurance operations.

Our combined ratio (on a statutory basis and excluding structured settlements and financial reinsurance) fell from 111 in 1985 to 103 in 1986. In addition, our premium growth has been exceptional: although final figures aren't available, I believe that over the past two years we were the fastest growing company among the country's top 100 insurers. Some of our growth, it is true, came from our large quota-share contract with Fireman's Fund, described in last year's report and updated in Charlie's letter on page 54. But even if the premiums from that contract are excluded from the calculation, we probably still ranked first in growth.

Interestingly, we were the slowest-growing large insurer in the years immediately preceding 1985. In fact, we shrank — and we will do so again from time to time in the future. Our large swings in volume do not mean that we come and go from the insurance marketplace. Indeed, we are its most steadfast participant, always standing ready, at prices we believe adequate, to write a wide variety of high-limit coverages. The swings in our volume arise instead from the here-today, gone-tomorrow behavior of other insurers. When most insurers are "gone," because their capital is inadequate or they have been frightened by losses, insureds rush to us — and find us ready to do business. But when hordes of insurers are "here," and are slashing prices far below expectable costs, many customers naturally leave us in order to take advantage of the bargains temporarily being offered by our competition.

Our firmness on prices works no hardship on the consumer: he is being bombarded by attractively-priced insurance offers at those times when we are doing little business. And it works no hardship on our employees: we don't engage in layoffs when we experience a cyclical slowdown at one of our generally-profitable insurance operations. This no-layoff practice is in our self-interest. Employees who fear that large layoffs will accompany sizable reductions in premium volume will understandably produce scads of business through thick and thin (mostly thin).

The trends in National Indemnity's traditional business — the writing of commercial auto and general liability policies through general agents — suggest how gun-shy other insurers became for a while and how brave they are now getting. In the last quarter of 1984, NICO's monthly volume averaged $5 million, about what it had been running for several years. By the first quarter of 1986, monthly volume had climbed to about $35 million. In recent months, a sharp decline has set in. Monthly volume is currently about $20 million and will continue to fall as new competitors surface and prices are cut. Ironically, the managers of certain major new competitors are the very same managers that just a few years ago bankrupted insurers that were our old competitors. Through state-mandated guaranty funds, we must pay some of the losses these managers left unpaid, and now we find them writing the same sort of business under a new name. C'est la guerre.

The business we call "large risks" expanded significantly during 1986, and will be important to us in the future. In this operation, we regularly write policies with annual premiums of $1 — $3 million, or even higher. This business will necessarily be highly volatile — both in volume and profitability — but our premier capital position and willingness to write large net lines make us a very strong force in the market when prices are right. On the other hand, our structured settlement business has become near-dormant because present prices make no sense to us.

The 1986 loss reserve development of our insurance group is chronicled on page 46. The figures show the amount of error in our yearend 1985 liabilities that a year of settlements and further evaluation has revealed. As you can see, what I told you last year about our loss liabilities was far from true — and that makes three years in a row of error. If the physiological rules that applied to Pinocchio were to apply to me, my nose would now draw crowds.

When insurance executives belatedly establish proper reserves, they often speak of "reserve strengthening," a term that has a rather noble ring to it. They almost make it sound as if they are adding extra layers of strength to an already-solid balance sheet. That's not the case: instead the term is a euphemism for what should more properly be called "correction of previous untruths" (albeit non-intentional ones).

We made a special effort at the end of 1986 to reserve accurately. However, we tried just as hard at the end of 1985. Only time will tell whether we have finally succeeded in correctly estimating our insurance liabilities.

Despite the difficulties we have had in reserving and the commodity economics of the industry, we expect our insurance business to both grow and make significant amounts of money — but progress will be distinctly irregular and there will be major unpleasant surprises from time to time. It's a treacherous business and a wary attitude is essential. We must heed Woody Allen: "While the lamb may lie down with the lion, the lamb shouldn't count on getting a whole lot of sleep."

In our insurance operations we have an advantage in attitude, we have an advantage in capital, and we are developing an advantage in personnel. Additionally, I like to think we have some long-term edge in investing the float developed from policyholder funds. The nature of the business suggests that we will need all of these advantages in order to prosper.

* * *

GEICO Corporation, 41% owned by Berkshire, had an outstanding year in 1986. Industrywide, underwriting experience in personal lines did not improve nearly as much as it did in commercial lines. But GEICO, writing personal lines almost exclusively, improved its combined ratio to 96.9 and recorded a 16% gain in premium volume. GEICO also continued to repurchase its own shares and ended the year with 5.5% fewer shares outstanding than it had at the start of the year. Our share of GEICO's premium volume is over $500 million, close to double that of only three years ago. GEICO's book of business is one of the best in the world of insurance, far better indeed than Berkshire's own book.

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The most important ingredient in GEICO's success is rock-bottom operating costs, which set the company apart from literally hundreds of competitors that offer auto insurance. The total of GEICO's underwriting expense and loss adjustment expense in 1986 was only 23.5% of premiums. Many major companies show percentages 15 points higher than that. Even such huge direct writers as Allstate and State Farm incur appreciably higher costs than does GEICO.

The difference between GEICO's costs and those of its competitors is a kind of moat that protects a valuable and much-sought-after business castle. No one understands this moat-around-the-castle concept better than Bill Snyder, Chairman of GEICO. He continually widens the moat by driving down costs still more, thereby defending and strengthening the economic franchise. Between 1985 and 1986, GEICO's total expense ratio dropped from 24.1% to the 23.5% mentioned earlier and, under Bill's leadership, the ratio is almost certain to drop further. If it does — and if GEICO maintains its service and underwriting standards — the company's future will be brilliant indeed.

The second stage of the GEICO rocket is fueled by Lou Simpson, Vice Chairman, who has run the company's investments since late 1979. Indeed, it's a little embarrassing for me, the fellow responsible for investments at Berkshire, to chronicle Lou's performance at GEICO. Only my ownership of a controlling block of Berkshire stock makes me secure enough to give you the following figures, comparing the overall return of the equity portfolio at GEICO to that of the Standard & Poor's 500:

Year	GEICO's Equities	S&P 500
1980	23.7%	32.3%
1981	5.4	(5.0)
1982	45.8	21.4
1983	36.0	22.4
1984	21.8	6.2
1985	45.8	31.6
1986	38.7	18.6

These are not only terrific figures but, fully as important, they have been achieved in the right way. Lou has consistently invested in undervalued common stocks that, individually, were unlikely to present him with a permanent loss and that, collectively, were close to risk-free.

In sum, GEICO is an exceptional business run by exceptional managers. We are fortunate to be associated with them.

Marketable Securities

During 1986, our insurance companies purchased about $700 million of tax-exempt bonds, most having a maturity of 8 to 12 years. You might think that this commitment indicates a considerable enthusiasm for such bonds. Unfortunately, that's not so: at best, the bonds are mediocre investments. They simply seemed the least objectionable alternative at the time we bought them, and still seem so. (Currently liking neither stocks nor bonds, I find myself the polar opposite of Mae West as she declared: "I like only two kinds of men — foreign and domestic.")

We must, of necessity, hold marketable securities in our insurance companies and, as money comes in, we have only five directions to go: (1) long-term common stock investments; (2) long-term fixed-income securities; (3) medium-term fixed-income securities; (4) short-term cash equivalents; and (5) short-term arbitrage commitments.

Common stocks, of course, are the most fun. When conditions are right — that is, when companies with good economics and good management sell well below intrinsic business value — stocks sometimes provide grand-slam home runs. But we currently find no equities that come close to meeting our tests. This statement in no way translates into a stock market prediction: we have no idea — and never have had — whether the market is going to go up, down, or sideways in the near- or intermediate-term future.

What we do know, however, is that occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable. And the market aberrations produced by them will be equally unpredictable, both as to duration and degree. Therefore, we never try to anticipate the arrival or departure of either disease. Our goal is more modest: we simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.

As this is written, little fear is visible in Wall Street. Instead, euphoria prevails — and why not? What could be more exhilarating than to participate in a bull market in which the rewards to owners of businesses become gloriously uncoupled from the plodding performances of the businesses themselves. Unfortunately, however, stocks can't outperform businesses indefinitely.

Indeed, because of the heavy transaction and investment management costs they bear, stockholders as a whole and over the long term must inevitably underperform the companies they own. If American business, in aggregate, earns about 12% on equity annually, investors must end up earning significantly less. Bull markets can obscure mathematical laws, but they cannot repeal them.

The second category of investments open to our insurance companies is long-term bonds. These are unlikely to be of interest to us except in very special situations, such as the Washington Public Power Supply System #1, #2 and #3 issues, discussed in our 1984 report. (At yearend, we owned WPPSS issues having an amortized cost of $218 million and a market value of $310 million, paying us $31.7 million in annual tax-exempt income.) Our aversion to long-term bonds relates to our fear that we will see much higher rates of inflation within the next decade. Over time, the behavior of our currency will be determined by the behavior of our legislators. This relationship poses a continuing threat to currency stability — and a corresponding threat to the owners of long-term bonds.

We continue to periodically employ money in the arbitrage field. However, unlike most arbitrageurs, who purchase dozens of securities each year, we purchase only a few. We restrict ourselves to large deals that have been announced publicly and do not bet on the come. Therefore, our potential profits are apt to be small; but, with luck, our disappointments will also be few.

Our yearend portfolio shown below includes one arbitrage commitment, Lear-Siegler. Our balance sheet also includes a receivable for $145 million, representing the money owed us (and paid a few days later) by Unilever, then in the process of purchasing Chesebrough-Ponds, another of our arbitrage holdings. Arbitrage is an alternative to Treasury Bills as a short-term parking place for money — a choice that combines potentially higher returns with higher risks. To date, our returns from the funds committed to arbitrage have been many times higher than they would have been had we left those funds in Treasury Bills. Nonetheless, one bad experience could change the scorecard markedly.

We also, though it takes some straining, currently view medium-term tax-exempt bonds as an alternative to short-term Treasury holdings. Buying these bonds, we run a risk of significant loss if, as seems probable, we sell many of them well before maturity. However, we believe this risk is more than counter-balanced first, by the much higher after-tax returns currently realizable from these securities as compared to Treasury Bills and second, by the possibility that sales will produce an overall profit rather than a loss. Our expectation of a higher total return, after allowing for the possibility of loss and after taking into account all tax effects, is a relatively close call and could well be wrong. Even if we sell our bonds at a fairly large loss, however, we may end up reaping a higher after-tax return than we would have realized by repeatedly rolling over Treasury Bills.

In any event, you should know that our expectations for both the stocks and bonds we now hold are exceptionally modest, given current market levels. Probably the best thing that could happen to us is a market in which we would choose to sell many of our bond holdings at a significant loss in order to re-allocate funds to the far-better equity values then very likely to exist. The bond losses I am talking about would occur if high interest rates came along; the same rates would probably depress common stocks considerably more than medium-term bonds.

We show below our 1986 yearend net holdings in marketable equities. All positions with a market value of over $25 million are listed, and the interests attributable to minority shareholdings of Wesco Financial Corp. and Nebraska Furniture Mart are excluded.

No. of Shares		*Cost*	*Market*
		(000s omitted)	
2,990,000	Capital Cities/ABC, Inc.	$515,775	$ 801,694
6,850,000	GEICO Corporation	45,713	674,725
2,379,200	Handy & Harman	27,318	46,989
489,300	Lear Siegler, Inc.	44,064	44,587
1,727,765	The Washington Post Company	9,731	269,531
		642,601	1,837,526
	All Other Common Stockholdings	12,763	36,507
	Total Common Stocks	$655,364	$1,874,033

We should note that we expect to keep permanently our three primary holdings, Capital Cities/ABC, Inc., GEICO Corporation, and The Washington Post. Even if these securities were to appear significantly overpriced, we would not anticipate selling them, just as we would not sell See's or Buffalo Evening News if someone were to offer us a price far above what we believe those businesses are worth.

This attitude may seem old-fashioned in a corporate world in which activity has become the order of the day. The modern manager refers to his "portfolio" of businesses — meaning that all of them are candidates for "restructuring" whenever such a move is dictated by Wall Street preferences, operating conditions or a new corporate "concept." (Restructuring is defined narrowly, however: it extends only to dumping offending businesses, not to dumping the officers and directors who bought the businesses in the first place. "Hate the sin but love the sinner" is a theology as popular with the Fortune 500 as it is with the Salvation Army.)

Investment managers are even more hyperkinetic: their behavior during trading hours makes whirling dervishes appear sedated by comparison. Indeed, the term "institutional investor" is becoming one of those self-contradictions called an oxymoron, comparable to "jumbo shrimp," "lady mud-wrestler" and "inexpensive lawyer."

Despite the enthusiasm for activity that has swept business and financial America, we will stick with our 'til-death-do-us-part policy. It's the only one with which Charlie and I are comfortable, it produces decent results, and it lets our managers and those of our investees run their businesses free of distractions.

NHP, Inc.

Last year we paid $23.7 million for about 50% of NHP, Inc., a developer, syndicator, owner and manager of multi-family rental housing. Should all executive stock options that have been authorized be granted and exercised, our equity interest will decline to slightly over 45%.

NHP, Inc. has a most unusual genealogy. In 1967, President Johnson appointed a commission of business and civic leaders, led by Edgar Kaiser, to study ways to increase the supply of multi-family housing for low- and moderate-income tenants. Certain members of the commission subsequently formed and promoted two business entities to foster this goal. Both are now owned by NHP, Inc. and one operates under unusual ground rules: three of its directors must be appointed by the President, with the advice and consent of the Senate, and it is also required by law to submit an annual report to the President.

Over 260 major corporations, motivated more by the idea of public service than profit, invested $42 million in the two original entities, which promptly began, through partnerships, to develop government-subsidized rental property. The typical partnership owned a single property and was largely financed by a non-recourse mortgage. Most of the equity money for each partnership was supplied by a group of limited partners who were primarily attracted by the large tax deductions that went with the investment. NHP acted as general partner and also purchased a small portion of each partnership's equity.

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$50 million annually.

NHP now oversees about 500 partnership properties that are located in 40 states, the District of Columbia and Puerto Rico, and that include about 80 000 housing units. The cost of these properties was more than $2.5 billion and they have been well maintained. NHP directly manages about 55,000 of the housing units and supervises the management of the rest. The company's revenues from management are about $16 million annually, and growing.

In addition to the equity interests it purchased upon the formation of each partnership, NHP owns varying residual interests that come into play when properties are disposed of and distributions are made to the limited partners. The residuals on many of NHP's "deep subsidy" properties are unlikely to be of much value. But residuals on certain other properties could prove quite valuable, particularly if inflation should heat up.

The tax-oriented syndication of properties to individuals has been halted by the Tax Reform Act of 1986. In the main, NHP is currently trying to develop equity positions or significant residual interests in non-subsidized rental properties of quality and size (typically 200 to 500 units). In projects of this kind, NHP usually works with one or more large institutional investors or lenders. NHP will continue to seek ways to develop low- and moderate-income apartment housing, but will not likely meet success unless government policy changes.

Besides ourselves, the large shareholders in NHP are Weyerhauser (whose interest is about 25%) and a management group led by Rod Heller, chief executive of NHP. About 60 major corporations also continue to hold small interests, none larger than 2%.

Taxation

The Tax Reform Act of 1986 affects our various businesses in important and divergent ways. Although we find much to praise in the Act, the net financial effect for Berkshire is negative: our rate of increase in business value is likely to be at least moderately slower under the new law than under the old. The net effect for our shareholders is even more negative: every dollar of increase in per-share business value, assuming the increase is accompanied by an equivalent dollar gain in the market value of Berkshire stock, will produce 72¢ of after-tax gain for our shareholders rather than the 80¢ produced under the old law. This result, of course, reflects the rise in the maximum tax rate on personal capital gains from 20% to 28%.

Here are the main tax changes that affect Berkshire:

- The tax rate on corporate ordinary income is scheduled to decrease from 46% in 1986 to 34% in 1988. This change obviously affects us positively — and it also has a significant positive effect on two of our three major investees, Capital Cities/ABC and The Washington Post Company.

I say this knowing that over the years there has been a lot of fuzzy and often partisan commentary about who really pays corporate taxes -- businesses or their customers. The argument, of course, has usually turned around tax increases, not decreases. Those people resisting increases in corporate rates frequently argue that corporations in reality pay none of the taxes levied on them but, instead, act as a sort of economic pipeline, passing all taxes through to consumers. According to these advocates, any corporate-tax increase will simply lead to higher prices that, for the corporation, offset the increase. Having taken this position, proponents of the "pipeline" theory must also conclude that a tax decrease for corporations will not help profits but will instead flow through, leading to correspondingly lower prices for consumers.

Conversely, others argue that corporations not only pay the taxes levied upon them, but absorb them also. Consumers, this school says, will be unaffected by changes in corporate rates.

What really happens? When the corporate rate is cut, do Berkshire, The Washington Post, Cap Cities, etc., themselves soak up the benefits, or do these companies pass the benefits along to their customers in the form of lower prices? This is an important question for investors and managers, as well as for policymakers.

Our conclusion is that in some cases the benefits of lower corporate taxes fall exclusively, or almost exclusively, upon the corporation and its shareholders, and that in other cases the benefits are entirely, or almost entirely, passed through to the customer. What determines the outcome is the strength of the corporation's business franchise and whether the profitability of that franchise is regulated.

For example, when the franchise is strong and after-tax profits are regulated in a relatively precise manner, as is the case with electric utilities, changes in corporate tax rates are largely reflected in prices, not in profits. When taxes are cut, prices will usually be reduced in short order. When taxes are increased, prices will rise, though often not as promptly.

A similar result occurs in a second arena — in the price-competitive industry, whose companies typically operate with very weak business franchises. In such industries, the free market "regulates" after-tax profits in a delayed and irregular, but generally effective, manner. The marketplace, in effect, performs much the same function in dealing with the price-competitive industry as the Public Utilities Commission does in dealing with electric utilities. In these industries, therefore, tax changes eventually affect prices more than profits.

In the case of unregulated businesses blessed with strong franchises, however, it's a different story: the corporation and its shareholders are then the major beneficiaries of tax cuts. These companies benefit from a tax cut much as the electric company would if it lacked a regulator to force down prices.

Many of our businesses, both those we own in whole and in part, possess such franchises. Consequently, reductions in their taxes largely end up in our pockets rather than the pockets of our customers. While this may be impolitic to state, it is impossible to deny. If you are tempted to believe otherwise, think for a moment of the most able brain surgeon or lawyer in your area. Do you really expect the fees of this expert (the local "franchise-holder" in his or her specialty) to be reduced now that the top personal tax rate is being cut from 50% to 28%?

Your joy at our conclusion that lower rates benefit a number of our operating businesses and investees should be severely tempered, however, by another of our convictions: scheduled 1988 tax rates, both individual and corporate, seem totally unrealistic to us. These rates will very likely bestow a fiscal problem on Washington that will prove incompatible with price stability. We believe, therefore, that ultimately — within, say, five years — either higher tax rates or higher inflation rates are almost certain to materialize. And it would not surprise us to see both.

- Corporate capital gains tax rates have been increased from 28% to 34%, effective in 1987. This change will have an important adverse effect on Berkshire because we expect much of our gain in business value in the future, as in the past, to arise from capital gains. For example, our three major investment holdings — Cap Cities, GEICO, and Washington Post — at yearend had a market value of over $1.7 billion, close to 75% of the total net worth of Berkshire, and yet they deliver us only about $9 million in annual income. Instead, all three retain a very high percentage of their earnings, which we expect to eventually deliver us capital gains.

The new law increases the rate for all gains realized in the future, including the unrealized gains that existed before the law was enacted. At yearend, we had $1.2 billion of such unrealized gains in our equity investments. The effect of the new law on our balance sheet will be delayed because a GAAP rule stipulates that the deferred tax liability applicable to unrealized gains should be stated at last year's 28% tax rate rather than the current 34% rate. This rule is expected to change soon. The moment it does, about $73 million will disappear from our GAAP net worth and be added to the deferred tax account.

- Dividend and interest income received by our insurance companies will be taxed far more heavily under the new law. First, all corporations will be taxed on 20% of the dividends they receive from other domestic corporations, up from 15% under the old law. Second, there is a change concerning the residual 80% that applies only to property/casualty companies: 15% of that residual will be taxed if the stocks paying the dividends were purchased after August 7, 1986. A third change, again applying only to property/casualty companies, concerns tax-exempt bonds: interest on bonds purchased by insurers after August 7, 1986 will only be 85% tax-exempt.

The last two changes are very important. They mean that our income from the investments we make in future years will be significantly lower than would have been the case under the old law. My best guess is that these changes alone will eventually reduce the earning power of our insurance operation by at least 10% from what we could previously have expected.

- The new tax law also materially changes the timing of tax payments by property/casualty insurance companies. One new rule requires us to discount our loss reserves in our tax returns, a change that will decrease deductions and increase taxable income. Another rule, to be phased in over six years, requires us to include 20% of our unearned premium reserve in taxable income.

Neither rule changes the amount of the annual tax accrual in our reports to you, but each materially accelerates the schedule of payments. That is, taxes formerly deferred will now be front-ended, a change that will significantly cut the profitability of our business. An analogy will suggest the toll: if, upon turning 21, you were required to immediately pay tax on all income you were due to receive throughout your life, both your lifetime wealth and your estate would be a small fraction of what they would be if all taxes on your income were payable only when you died.

Attentive readers may spot an inconsistency in what we say. Earlier, discussing companies in price-competitive industries, we suggested that tax increases or reductions affect these companies relatively little, but instead are largely passed along to their customers. But now we are saying that tax increases will affect profits of Berkshire's property/casualty companies even though they operate in an intensely price-competitive industry.

The reason this industry is likely to be an exception to our general rule is that not all major insurers will be working with identical tax equations. Important differences will exist for several reasons: a new alternative minimum tax will materially affect some companies but not others; certain major insurers have huge loss carry-forwards that will largely shield their income from significant taxes for at least a few years; and the results of some large insurers will be folded into the consolidated returns of companies with non-insurance businesses. These disparate conditions will produce widely-varying marginal tax rates in the property/casualty industry. That will not be the case, however, in most other price-competitive industries, such as aluminum, autos and department stores, in which the major players will generally contend with similar tax equations.

The absence of a common tax calculus for property/casualty companies means that the increased taxes falling on the industry will probably not be passed along to customers to the degree that they would in a typical price-competitive industry. Insurers, in other words, will themselves bear much of the new tax burdens.

- A partial offset to these burdens is a "fresh start" adjustment that occurred on January 1, 1987 when our December 31, 1986 loss reserve figures were converted for tax purposes to the newly-required discounted basis. (In our reports to you, however, reserves will remain on exactly the same basis as in the past — undiscounted except in special cases such as structured settlements.) The net effect of the "fresh start" is to give us a double deduction: we will get a tax deduction in 1987 and future years for a portion of our incurred-but-unpaid insurance losses that have already been fully deducted as costs in 1986 and earlier years.

The increase in net worth that is produced by this change is not yet reflected in our financial statements. Rather, under present GAAP rules (which may be changed), the benefit will flow into the earnings statement and, consequently, into net worth over the next few years by way of reduced tax charges. We expect the total benefit from the fresh-start adjustment to be in the $30 — $40 million range. It should be noted, however, that this is a one-time benefit, whereas the negative impact of the other insurance-related tax changes is not only ongoing but, in important respects, will become more severe as time passes.

- The General Utilities Doctrine was repealed by the new tax law. This means that in 1987 and thereafter there will be a double tax on corporate liquidations, one at the corporate level and another at the shareholder level. In the past, the tax at the corporate level could be avoided. If Berkshire, for example, were to be liquidated — which it most certainly won't be — shareholders would, under the new law, receive far less from the sales of our properties than they would have if the properties had been sold in the past, assuming identical prices in each sale. Though this outcome is theoretical in our case, the change in the law will very materially affect many companies. Therefore, it also affects our evaluations of prospective investments. Take, for example, producing oil and gas businesses, selected media companies, real estate companies, etc. that might wish to sell out. The values that their shareholders can realize are likely to be significantly reduced simply because the General Utilities Doctrine has been repealed — though the companies' operating economics will not have changed adversely at all. My impression is that this important change in the law has not yet been fully comprehended by either investors or managers.

This section of our report has been longer and more complicated than I would have liked. But the changes in the law are many and important, particularly for property/casualty insurers. As I have noted, the new law will hurt Berkshire's results, but the negative impact is impossible to quantify with any precision.

Miscellaneous

We bought a corporate jet last year. What you have heard about such planes is true: they are very expensive and a luxury in situations like ours where little travel to out-of-the-way places is required. And planes not only cost a lot to operate, they cost a lot just to look at. Pre-tax, cost of capital plus depreciation on a new $15 million plane probably runs $3 million annually. On our own plane, bought for $850,000 used, such costs run close to $200,000 annually.

Cognizant of such figures, your Chairman, unfortunately, has in the past made a number of rather intemperate remarks about corporate jets. Accordingly, prior to our purchase, I was forced into my Galileo mode. I promptly experienced the necessary "counter-revelation" and travel is now considerably easier — and considerably costlier — than in the past. Whether Berkshire will get its money's worth from the plane is an open question, but I will work at achieving some business triumph that I can (no matter how dubiously) attribute to it. I'm afraid Ben Franklin had my number. Said he: "So convenient a thing it is to be a reasonable creature, since it enables one to find or make a reason for everything one has a mind to do."

* * *

About 97% of all eligible shares participated in Berkshire's 1986 shareholder-designated contributions program. Contributions made through the program were $4 million, and 1,934 charities were recipients.

We urge new shareholders to read the description of our shareholder-designated contributions program that appears on pages 58 and 59. If you wish to participate in future programs, we strongly urge that you immediately make sure your shares are registered in the name of the actual owner, not in "street" name or nominee name. Shares not so registered on September 30, 1987 will be ineligible for the 1987 program.

* * *

Last year almost 450 people attended our shareholders' meeting, up from about 250 the year before (and from about a dozen ten years ago). I hope you can join us on May 19th in Omaha. Charlie and I like to answer owner-related questions and I can promise you that our shareholders will pose many good ones. Finishing up the questions may take quite a while — we had about 65 last year — so you should feel free to leave once your own have been answered.

Last year, after the meeting, one shareholder from New Jersey and another from New York went to the Furniture Mart, where each purchased a $5,000 Oriental rug from Mrs. B. (To be precise, they purchased rugs that might cost $10,000 elsewhere for which they were charged about $5,000.) Mrs. B was pleased — but not satisfied — and she will be looking for you at the store after this year's meeting. Unless our shareholders top last year's record, I'll be in trouble. So do me (and yourself) a favor, and go see her.

Warren E. Buffett
Chairman of the Board

February 27, 1987

Purchase-Price Accounting Adjustments and the "Cash Flow" Fallacy

First a short quiz: below are abbreviated 1986 statements of earnings for two companies. Which business is the more valuable?

		Company O		*Company N*
			(000s Omitted)	
Revenues		$677,240		$677,240
Cost of Goods Sold:				
Historical costs, excluding depreciation	$341,170		$341,170	
Special non-cash inventory costs			4,979 [1]	
Depreciation of plant and equipment	8,301		13,355 [2]	
		349,471		359,504
Gross Profit		$327,769		$317,736
Selling & Admin. Expense	$260,286		$260,286	
Amortization of Goodwill			595 [3]	
		260,286		260,881
Operating Profit		$ 67,483		$ 56,855
Other Income, Net		4,135		4,135
Pre-Tax Income		$ 71,618		$ 60,990
Applicable Income Tax:				
Historical deferred and current tax	$ 31,387		$ 31,387	
Non-Cash Inter-period Allocation Adjustment			998 [4]	
		31,387		32,385
Net Income		$ 40,231		$ 28,605

(Numbers (1) through (4) designate items discussed later in this section.)

As you've probably guessed, Companies O and N are the same business — Scott Fetzer. In the "O" (for "old") column we have shown what the company's 1986 GAAP earnings would have been if we had not purchased it; in the "N" (for "new") column we have shown Scott Fetzer's GAAP earnings as actually reported by Berkshire.

It should be emphasized that the two columns depict identical economics — i.e., the same sales, wages, taxes, etc. And both "companies" generate the same amount of cash for owners. Only the accounting is different.

So, fellow philosophers, which column presents truth? Upon which set of numbers should managers and investors focus?

Before we tackle those questions, let's look at what produces the disparity between O and N. We will simplify our discussion in some respects, but the simplification should not produce any inaccuracies in analysis or conclusions.

The contrast between O and N comes about because we paid an amount for Scott Fetzer that was different from its stated net worth. Under GAAP, such differences — such premiums or discounts — must be accounted for by "purchase-price adjustments." In Scott Fetzer's case, we paid $315 million for net assets that were carried on its books at $172.4 million. So we paid a premium of $142.6 million.

The first step in accounting for any premium paid is to adjust the carrying value of current assets to current values. In practice, this requirement usually does not affect receivables, which are routinely carried at current value, but often affects inventories. Because of a $22.9 million LIFO reserve and other accounting intricacies, Scott Fetzer's inventory account was carried at a $37.3 million discount from current value. So, making our first accounting move, we used $37.3 million of our $142.6 million premium to increase the carrying value of the inventory.

Assuming any premium is left after current assets are adjusted, the next step is to adjust fixed assets to current value. In our case, this adjustment also required a few accounting acrobatics relating to deferred taxes. Since this has been billed as a simplified discussion, I will skip the details and give you the bottom line: $68.0 million was added to fixed assets and $13.0 million was eliminated from deferred tax liabilities. After making this $81.0 million adjustment, we were left with $24.3 million of premium to allocate.

Had our situation called for them, two steps would next have been required: the adjustment of intangible assets other than Goodwill to current fair values, and the restatement of liabilities to current fair values, a requirement that typically affects only long-term debt and unfunded pension liabilities. In Scott Fetzer's case, however, neither of these steps was necessary.

The final accounting adjustment we needed to make, after recording fair market values for all assets and liabilities, was the assignment of the residual premium to Goodwill (technically known as "excess of cost over the fair value of net assets acquired"). This residual amounted to $24.3 million. Thus, the balance sheet of Scott Fetzer immediately before the acquisition, which is summarized below in column O, was transformed by the purchase into the balance sheet shown in column N. In real terms, both balance sheets depict the same assets and liabilities -- but, as you can see, certain figures differ significantly.

	Company O	*Company N*
	(000s Omitted)	
Assets		
Cash and Cash Equivalents	$ 3,593	$ 3,593
Receivables, net	90,919	90,919
Inventories	77,489	114,764
Other	5,954	5,954
Total Current Assets	177,955	215,230
Property, Plant, and Equipment, net	80,967	148,960
Investments in and Advances to Unconsolidated Subsidiaries and Joint Ventures	93,589	93,589
Other Assets, including Goodwill	9,836	34,210
	$362,347	$491,989
Liabilities		
Notes Payable and Current Portion of Long-term Debt	$ 4,650	$ 4,650
Accounts Payable	39,003	39,003
Accrued Liabilities	84,939	84,939
Total Current Liabilities	128,592	128,592
Long-term Debt and Capitalized Leases	34,669	34,669
Deferred Income Taxes	17,052	4,075
Other Deferred Credits	9,657	9,657
Total Liabilities	189,970	176,993
Shareholders' Equity	172,377	314,996
	$362,347	$491,989

The higher balance sheet figures shown in column N produce the lower income figures shown in column N of the earnings statement presented earlier. This is the result of the asset write-ups and of the fact that some of the written-up assets must be depreciated or amortized. The higher the asset figure, the higher the annual depreciation or amortization charge to earnings must be. The charges that flowed to the earnings statement because of the balance sheet write-ups were numbered in the statement of earnings shown earlier:

1. $4,979,000 for non-cash inventory costs resulting, primarily, from reductions that Scott Fetzer made in its inventories during 1986; charges of this kind are apt to be small or non-existent in future years.
2. $5,054,000 for extra depreciation attributable to the write-up of fixed assets; a charge approximating this amount will probably be made annually for 12 more years.
3. $595,000 for amortization of Goodwill; this charge will be made annually for 39 more years in a slightly larger amount because our purchase was made on January 6 and, therefore, the 1986 figure applies to only 98% of the year.
4. $998,000 for deferred-tax acrobatics that are beyond my ability to explain briefly (or perhaps even non-briefly); a charge approximating this amount will probably be made annually for 12 more years.

It is important to understand that none of these newly-created accounting costs, totaling $11.6 million, are deductible for income tax purposes. The "new" Scott Fetzer pays exactly the same tax as the "old" Scott Fetzer would have, even though the GAAP earnings of the two entities differ greatly. And, in respect to operating earnings, that would be true in the future also. However, in the unlikely event that Scott Fetzer sells one of its businesses, the tax consequences to the "old" and "new" company might differ widely.

By the end of 1986 the difference between the net worth of the "old" and "new" Scott Fetzer had been reduced from $142.6 million to $131.0 million by means of the extra $11.6 million that was charged to earnings of the new entity. As the years go by, similar charges to earnings will cause most of the premium to disappear, and the two balance sheets will converge. However, the higher land values and most of the higher inventory values that were established on the new balance sheet will remain unless land is disposed of or inventory levels are further reduced.

* * *

What does all this mean for owners? Did the shareholders of Berkshire buy a business that earned $40.2 million in 1986 or did they buy one earning $28.6 million? Were those $11.6 million of new charges a real economic cost to us? Should investors pay more for the stock of Company O than of Company N? 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. But calculations of this sort usually do not provide such pleasant news. 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 oil industry has in recent years provided a conspicuous example of this phenomenon. Had most major oil companies spent only (b) each year, they would have guaranteed their shrinkage in real terms.

All of this points up the absurdity of the "cash flow" numbers that are often set forth in Wall Street reports. These numbers routinely include (a) plus (b) — but do not subtract (c). Most sales brochures of investment bankers also feature deceptive presentations of this kind. These imply that the business being offered is the commercial counterpart of the Pyramids — forever state-of-the-art, never needing to be replaced, improved or refurbished. Indeed, if all U.S. corporations were to be offered simultaneously for sale through our leading investment bankers — and if the sales brochures describing them were to be believed — governmental projections of national plant and equipment spending would have to be slashed by 90%.

"Cash Flow," true, may serve as a shorthand of some utility in descriptions of certain real estate businesses or other enterprises that make huge initial outlays and only tiny outlays thereafter. A company whose only holding is a bridge or an extremely long-lived gas field would be an example. But "cash flow" is meaningless in such businesses as manufacturing, retailing, extractive companies, and utilities because, for them, (c) is always significant. To be sure, businesses of this kind may in a given year be able to defer capital spending. But over a five- or ten-year period, they must make the investment — or the business decays.

Why, then, are "cash flow" numbers so popular today? In answer, we confess our cynicism: we believe these numbers are frequently used by marketers of businesses and securities in attempts to justify the unjustifiable (and thereby to sell what should be the unsalable). When (a) — that is, GAAP earnings — looks by itself inadequate to service debt of a junk bond or justify a foolish stock price, how convenient it becomes for salesmen to focus on (a) + (b). But you shouldn't add (b) without subtracting (c): though dentists correctly claim that if you ignore your teeth they'll go away, the same is not true for (c). The company or investor believing that the debt-servicing ability or the equity valuation of an enterprise can be measured by totalling (a) and (b) while ignoring (c) is headed for certain trouble.

* * *

To sum up: in the case of both Scott Fetzer and our other businesses, we feel that (b) on an historical-cost basis — i.e., with both amortization of intangibles and other purchase-price adjustments excluded — is quite close in amount to (c). (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. After all, what are we paying the accountants for if it is not to deliver us the "truth" about our business. But the accountants' job is to record, not to evaluate. The evaluation job falls to investors and managers.

Accounting numbers, of course, are the language of business and as such are of enormous help to anyone evaluating the worth of a business and tracking its progress. Charlie and I would be lost without these numbers: they invariably are the starting point for us in evaluating our own businesses and those of others. Managers and owners need to remember, however, that accounting is but an aid to business thinking, never a substitute for it.

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March 11, 1987

To the Board of Directors and Stockholders
Berkshire Hathaway Inc.

We have examined the consolidated balance sheets of Berkshire Hathaway Inc. and consolidated subsidiaries as of December 31, 1986 and December 28, 1985, and the related consolidated statements of earnings and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The consolidated statements of earnings and changes in financial position of Berkshire Hathaway Inc. and consolidated subsidiaries for the year ended December 29, 1984 were examined by other auditors whose report dated March 13, 1985, except as to Note 21 to the 1984 financial statements which was as of March 18, 1985, expressed an unqualified opinion on those statements.

In our opinion, the 1986 and 1985 consolidated financial statements referred to above present fairly the financial position of Berkshire Hathaway Inc. and consolidated subsidiaries as of December 31, 1986 and December 28, 1985, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Touche Ross & Co.

Touche Ross & Co.

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BERKSHIRE HATHAWAY INC.
and Consolidated Subsidiaries
CONSOLIDATED BALANCE SHEETS

(dollars in thousands except per share amounts)

	Dec. 31, 1986	Dec. 28, 1985
ASSETS		
Cash and temporary cash investments	$ 292,473	$1,017,667
Investments, other than investments in affiliates:		
Obligations with fixed maturities, principally bonds — at cost (market value: Dec. 31, 1986 — $1,274,342, Dec. 28, 1985 — $543,101)	1,124,389	475,216
Marketable equity securities (Notes 3, 4 and 5)	1,871,933	1,183,476
Accounts receivable from customers, agents and others (Note 6)	434,705	156,362
Inventories (Note 7)	159,660	37,386
Properties and equipment (Note 8)	212,211	69,369
Deferred insurance premium acquisition costs	79,146	51,368
Goodwill of acquired businesses	126,957	75,169
Other assets (Notes 9 and 10)	140,183	114,705
	$4,441,655	$3,180,718
LIABILITIES AND STOCKHOLDERS' EQUITY		
Losses and loss adjustment expenses	$ 860,228	$ 411,305
Unearned premiums	414,986	229,440
Accounts payable, accruals and other liabilities	236,157	120,823
Income taxes, principally deferred (Note 11)	414,275	381,581
Term debt and other borrowings (Note 12)	94,923	117,879
	2,020,569	1,261,028
Minority shareholders' interests	43,289	34,360
Stockholders' equity (Notes 13 and 14):		
Common stock of $5 par value. Authorized 1,500,000 shares; issued 1,375,183 shares, including shares held in treasury	6,876	6,876
Capital in excess of par value	157,377	157,377
Unrealized appreciation of marketable equity securities, net	874,813	664,707
Retained earnings	1,379,669	1,097,308
	2,418,735	1,926,268
Less common stock in treasury, at cost (228,274 shares)	40,938	40,938
Total stockholders' equity	2,377,797	1,885,330
Commitments (Note 10)		
	$4,441,655	$3,180,718

See accompanying Notes to Consolidated Financial Statements

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BERKSHIRE HATHAWAY INC.
and Consolidated Subsidiaries
CONSOLIDATED STATEMENTS OF EARNINGS
(dollars in thousands except per share amounts)

	Fiscal Year Ended		
		Saturday Nearest	
	December 31	*December 31*	
	1986	1985	1984
Income items:			
Sales and service revenues	$1.225,290	$ 508,764	$ 500,219
Insurance premiums earned	823,884	317,059	140,242
Interest and dividend income (Note 15)	118,429	107,662	84,161
Equity in earnings excluding realized investment gain of unconsolidated subsidiaries	9,062	6,379	4,557
	2,176,665	939,864	729,179
Cost and expense items:			
Cost of products and services sold	651,717	285,925	296,770
Insurance losses and loss adjustment expenses	655,758	280,249	141,550
Insurance underwriting expenses	223,970	81,040	46,752
Selling, general and administrative expenses	425,562	150,423	138,875
Interest and financing costs	23,892	14,415	14,734
	1.980,899	812,052	638,681
Earnings from operations including minority interest in consolidated subsidiaries, before applicable income taxes and before realized investment gain	195,766	127,812	90,498
Income taxes applicable to above (Note 11)	59,152	31,271	16,420
	136,614	96,541	74,078
Minority interest applicable to above	5,150	3,593	3,677
Earnings before realized investment gain	131,464	92,948	70,201
Realized investment gain, net (Note 16)	150,897	342,867	78,694
Net earnings	$ 282,361	$ 435,815	$ 148,895
Average shares outstanding	1,146,909	1,146,909	1,146,909
Per share:			
Earnings before realized investment gain	$ 114.62	$ 81.04	$ 61.21
Net earnings	246.19	379.99	129.82

See accompanying Notes to Consolidated Financial Statements

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BERKSHIRE HATHAWAY INC.
and Consolidated Subsidiaries

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

(dollars in thousands)

	Fiscal Year Ended		
		Saturday Nearest December 31	
	December 31 1986	1985	1984
Consolidated assets at beginning of year	$3,180,718	$2,035,203	$1,837,543
Changes during the year resulted from:			
Net earnings	282,361	435,815	148,895
Net increase in losses, loss adjustment expenses and unearned premiums of insurance subsidiaries	634,469	348,348	23,903
Net increase (decrease) in other consolidated liabilities	(76,999)	109,779	19,858
Increases essentially from operations	839,831	893,942	192,661
Net increase in unrealized appreciation included in carrying value of marketable securities	291,811	248,810	2,612
Repayment of debt	(69,097)	(9,298)	(1,922)
Net increase in minority interests	5,682	12,061	4,309
Obligations to which assets of purchased businesses were subject, when acquired:			
Term debt and other borrowings	46,141	—	—
Other liabilities	146,569	—	—
Total changes	1,260,937	1,145,515	197,660
Consolidated assets at end of year	$4,441,655	$3,180,718	$2,035,203

See accompanying Notes to Consolidated Financial Statements

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BERKSHIRE HATHAWAY INC.
and Consolidated Subsidiaries
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1986

(dollars in thousands except per share amounts)

(1) Significant Accounting Policies and Practices

(a) Basis of Consolidation

The accompanying Consolidated Financial Statements include the accounts of Berkshire Hathaway Inc. (the "Company" or "Berkshire") consolidated with accounts of all of its subsidiaries except as indicated in the immediately following paragraph. Consolidated subsidiaries include companies engaged in a number of diverse businesses. See Note 19.

(b) Unconsolidated Subsidiaries

An exception to Berkshire's practice of consolidation of all subsidiaries is made for those in which Berkshire's investments are minor and with respect to companies engaged in banking, savings and loan, or financing activities. Berkshire has indirectly owned 80.1% of Mutual Savings and Loan Association ("Mutual") since mid-1983. (Berkshire owned, beneficially, a lesser percentage of Mutual for several earlier years.) Since January 6, 1986 Berkshire has indirectly owned all of World Book Finance Inc. and United Consumer Financial Services Company, each engaged in financing activities. Berkshire's investments in subsidiaries not consolidated are accounted for using the equity method of accounting.

(c) Accounting Period

In 1986, Berkshire adopted the calendar year as its annual accounting period. For years prior to 1986, Berkshire used 52-53 week years that ended on the Saturday nearest December 31. With the exception of See's Candies, who continue to employ a 52-53 week year ending with respect to December 31, all of Berkshire's significant subsidiaries employed the calendar year for 1986 and for prior years. The change by the Company had no measurable effect upon 1986 consolidated earnings or year-end consolidated financial position.

(d) Investments in Securities, Other Than Affiliates

Investments in obligations with fixed dates of maturity — bonds and redeemable preferred stocks — are stated at cost, adjusted where appropriate for accretion of discount or amortization of premium.

Investments in marketable equity securities held by members of the Insurance Group are carried at market value. Investments in marketable equity securities held by consolidated subsidiaries which are not members of the Insurance Group are carried at the lower of aggregate cost or market.

Cost of securities sold is usually determined on a first-in, first-out basis. Occasionally, when specific identification of securities sold results in lower applicable income tax, identified cost is used.

(e) Inventories

Inventories are stated at the lower of cost or market. Cost has been determined on a last-in, first-out ("LIFO") basis for approximately 70% of total inventories at December 31, 1986 (26% at December 28, 1985). Cost for the remaining inventory has been determined using the first-in, first-out ("FIFO") or average cost methods.

(f) Properties and equipment

These items of property (including significant betterments and renewals) are carried at cost, depreciated principally on a straight line basis over their useful lives estimated at the date of acquisition. Maintenance, repairs and renewals of a minor nature are generally charged to operations as incurred.

(1) Significant Accounting Policies and Practices (Continued)

(g) Goodwill and Negative Goodwill of Acquired Businesses

The difference between purchase cost and the fair value of the net assets of acquired businesses is amortized on a straight line basis over forty years.

(h) Insurance Premium Acquisition Costs

For financial reporting purposes, certain costs of acquiring insurance premiums are deferred, subject to ultimate recoverability, and charged to income as the premiums are earned. With respect to premiums received under major quota-share reinsurance contracts, the computation of ultimate recoverability of the directly related acquisition costs takes into account investment income anticipated to be earned on funds held subject to the contracts. Otherwise, ultimate recoverability of premium acquisition costs is determined without regard to investment income. For statutory insurance accounting and through 1986, for income tax reporting purposes, premium acquisition costs are charged to income when incurred.

(j) Losses and Loss Adjustment Expenses

The Insurance Group provides for losses and loss adjustment expenses for unsettled cases based on estimates of ultimate liability with respect to reported cases, plus estimates of aggregate liability with respect to incurred but not reported losses. Estimates of liability relating to assumed reinsurance are based on loss reports received from the primary insurers. The liability provision is reduced for amounts recoverable on account of reinsurance ceded: these reductions amounted to $11,397 and $12,023 at December 31, 1986 and 1985, respectively.

An aggregate liability amounting to $52,029 and $40,841 at December 31, 1986 and 1985, respectively, was additionally established at present value on a contract-by-contract basis with respect to periodic payment obligations ("Structured Settlements") assumed by members of the Insurance Group. The specific present value discount rate applicable to a given contract is dependent upon market interest rates at the contract inception date. The weighted average discount rate for all such contracts at December 31, 1986 for financial reporting purposes was approximately 11.2%. For statutory insurance accounting and tax reporting purposes, these liabilities were discounted at a rate of 7% as prescribed by regulatory authority.

Additionally at December 31, 1986 and 1985, an aggregate liability amounting to $58,706 and $47,036, respectively, was established with respect to portfolio reinsurance obligations of the Insurance Group. Liabilities under these contracts are established at their inception dates at amounts approximately equal to the consideration then received, and thereafter at amounts determined by management to approximate the value of ultimate liability thereunder.

Incurred losses and loss adjustment expenses in the accompanying Consolidated Statements of Earnings are net of recoveries of salvage and subrogation collected or in process of collection in accordance with statutory accounting requirements for insurance companies.

(1) **Significant Accounting Policies and Practices** (Continued)

(k) *Insurance Premiums*

Insurance premiums are recognized as revenues ratably over the terms of the policies. Unearned premiums are computed on a monthly or daily pro rata basis and are stated after deduction of premiums for reinsurance placed with reinsurers in the amount of $3,567 and $4,398 at December 31, 1986 and 1985, respectively.

Dividends to policyholders are paid or credited to policyholders with respect to participating policies issued by certain members of the Berkshire Hathaway Insurance Group. These are reflected in the accompanying Consolidated Statements of Earnings as a deduction from earned premiums. This reduction amounted to $4,477 for 1986, $5,243 for 1985, and $3,110 for 1984.

(m) *Income Taxes*

Income taxes reflected in the consolidated financial statements represent those of the Company and those of its subsidiaries that are consolidated therein.

Certain items of income and deductions are recognized in the financial statements in time periods that differ from those in which they are recognized in the income tax returns filed for the companies giving rise to recognition in the financial statements of net deferred income taxes.

The liability for income taxes in Berkshire's consolidated balance sheets also includes Federal income taxes, computed at the rate of 28%, that applied through 1986 to long term capital gains, deemed applicable to unrealized appreciation included in carrying value of marketable securities.

(n) *Reclassifications*

In the accompanying presentation of financial statements for 1985 and 1984, certain reclassifications have been made when required to conform to current year presentation.

(2) Businesses Acquired

The Scott & Fetzer Company

In a cash merger transaction on January 6, 1986, Berkshire succeeded to all of the assets of The Scott & Fetzer Company ("Scott Fetzer") subject to all of Scott Fetzer's liabilities. Scott Fetzer, headquartered in Westlake, Ohio, conducts diversified manufacturing and marketing activities. Two of Scott Fetzer's principal product lines are vacuum cleaners and related accessories primarily for home use sold under the *Kirby* and other brand names, and encyclopedias and related products for education sold under the *World Book* and *Childcraft* names. Scott Fetzer had more than a dozen other operating units, the businesses of which involve manufacture and sale of a variety of products and services. The cash cost to Berkshire of the Scott Fetzer businesses was approximately $315,000. The business combination was accounted for as a purchase, and assets and liabilities of Scott Fetzer at estimated fair values as of January 6, 1986 were recorded as follows:

Current assets		$ 215,230
Properties and plants		148,960
Investment in unconsolidated finance subsidiaries		93,589
Other (including $26,687 goodwill)		34,210
		491,989
Liabilities, other than term debt	$ 137,674	
Term debt	39,319	176,993
Net assets		$ 314,996

Since the January 6, 1986 date of acquisition, the accounts of Scott Fetzer have been included in Berkshire's consolidated data except that the acquired unconsolidated finance subsidiaries are accounted for by the equity method of accounting.

The Fechheimer Brothers Company

In June, 1986, Berkshire acquired for approximately $46,000 cash approximately 84% of the outstanding capital stock of The Fechheimer Brothers Company, ("Fechheimer's"). This business is headquartered in Cincinnati, Ohio. It manufactures and distributes uniforms. This business combination was accounted for as a purchase. Assets, liabilities and minority interest of Fechheimer's recorded by Berkshire as of June 3, 1986, were as follows:

Current assets		$ 25,863
Property, plant and equipment		6,469
Other (including $28,279 goodwill)		29,259
		$ 61,591
Liabilities, other than term debt	$ 5,648	
Term debt	6,822	
Minority interest	3,247	15,717
		$ 45,874

Since the June 3, 1986 date of acquisition, the accounts of Fechheimer's have been included in Berkshire's consolidated data.

Pro Forma Data

The consolidated financial statements for 1985 do not reflect the accounts of Scott Fetzer and Fechheimer's. The following sets forth on an unaudited pro forma basis certain consolidated statement of earnings information for 1985, as if those businesses were acquired at the beginning of 1985, on the same purchase terms.

Total income items	$1,709,893
Net earnings	$ 447,817
Net earnings per share	$ 390.46

Similar information developed on a pro forma basis for 1986, as if those businesses were acquired at the very beginning of the current year, would not materially differ from that reflected in the accompanying Consolidated Statement of Earnings for 1986.

(3) Investments in Marketable Equity Securities

Aggregate data with respect to the consolidated investment in marketable equity securities is shown below as of the dates for which consolidated balance sheets are presented herein. See Note 1(d) as to methods applied to determine carrying value of these securities.

	December 31, 1986			
	Cost	*Unrealized Gain*	*Market*	*Carrying Value*
Common stock of:				
Capital Cities/ABC Inc.	$517,500	$ 286,875	$ 804,375	$ 799,594
GEICO Corporation	45,713	629,012	674,725	674,725
The Washington Post Company	9,731	259,800	269,531	269,531
All Others	84,145	43,938	128,083	128,083
	$657,089	$1,219,625	$1,876,714	$1,871,933

	December 31, 1985			
	Cost	*Unrealized Gain*	*Market*	*Carrying Value*
Common stock of:				
American Broadcasting Companies, Inc.	$ 54,435	$ 54,562	$ 108,997	$ 108,997
GEICO Corporation	45,713	550,237	595,950	595,950
The Washington Post Company	9,731	195,441	205,172	205,172
All Others	150,558	122,799	273,357	273,357
	$260,437	$923,039	$1,183,476	$1,183,476

There were no unrealized losses with respect to these securities at December 31, 1986 or at December 31, 1985.

(4) Investment in shares of Capital Cities/ABC Inc.

On January 2, 1986, subsidiaries of Berkshire acquired for $517,500 cash three million common shares of Capital Cities/ABC Inc. ("Capital Cities") pursuant to a Letter Agreement between Berkshire and Capital Cities dated March 18, 1985. The shares represented approximately 18.75% of the total outstanding shares of Capital Cities immediately after the transaction. Berkshire subsidiaries hold the shares subject to an Agreement the terms of which, among other provisions, grant to Capital Cities a right of first refusal to purchase the shares and otherwise govern until January 3, 1997 the manner by which the shares may be sold or transferred. Also, Berkshire and its subsidiaries have delivered to Capital Cities irrevocable proxies with respect to these shares in favor of Thomas S. Murphy so long as he shall be the chief executive officer of Capital Cities, or Daniel B. Burke, so long as he shall be the chief executive officer of Capital Cities, to vote the shares at any and all meetings of shareholders of Capital Cities. The proxies expire on January 2, 1997 or at the earlier date when neither of such persons is chief executive officer of Capital Cities.

(5) Investment in GEICO Corporation

Subsidiaries of Berkshire, at both December 31, 1986 and at December 28, 1985, owned 6,850,000 shares of common stock of GEICO Corporation. The shares possessed approximately 41% of the voting rights of all GEICO shares outstanding at December 31, 1986 (38-½% at December 28, 1985), but Berkshire holds the shares subject to an Order of the Superintendent of Insurance of the District of Columbia, the corporate domicile of GEICO, which prohibits Berkshire from exercising such rights. The Order provides that Berkshire must maintain an independent proxy arrangement for voting of these shares and prohibits Berkshire from seeking or causing to change the independent proxy. Also, under the Order, no officer or director of Berkshire or of any affiliate or subsidiary of Berkshire is permitted to serve as a director of GEICO. As a result of the Order, which divests Berkshire of its voting rights with respect to its GEICO holdings, Berkshire does not use the equity method of accounting for its investment in GEICO.

(6) Accounts Receivable

Accounts receivable from customers, agents and others were made up of the following:

	Dec. 31, 1986	Dec. 28, 1985
Trade accounts receivable, net of allowances for doubtful accounts	$128,800	$ 48,322
Agents' balances and premiums in course of collection	116,415	74,001
Reinsurance recoverable on loss payments	2,056	490
Investment income due and accrued	42,188	32,060
Amounts due from sale of securities	145,244	1,489
	$434,703	$156,362

(7) Inventories

Inventories of Berkshire's non-insurance businesses at the end of each of the last two years were as follows:

	Dec. 31, 1986	Dec. 28, 1985
Raw materials and supplies	$ 45,714	$ 18,095
Work-in-process	45,064	28
Finished goods	68,882	19,263
	$ 159,660	$ 37,386

Included in the totals are costs determined using the Last-in First-Out ("LIFO") method amounting to $112,021 at December 31, 1986 and $9,628 at December 28, 1985. The aggregate carrying value of inventories at December 31, 1986 is not materially different from aggregate current replacement cost.

Berkshire's acquisition of Scott Fetzer on January 6, 1986 was tax free to the constituent companies. In Berkshire's accounting pursuant to generally accepted accounting principles for the acquisition, it recorded the purchase at fair value on the acquisition date of Scott Fetzer's assets. Acquired assets included inventories with respect to which the LIFO cost method was and continues to be used for Federal income tax reporting purposes. As a result, at December 31, 1986 the above shown carrying value of inventories is $32,296 higher than used for Federal income tax reporting purposes.

(8) Properties and Equipment

The composition of properties and equipment at the end of the past two years is shown below:

	Dec. 31, 1986	Dec. 28, 1985
Land	$ 13,795	$ 7,455
Buildings	88,756	40,708
Machinery and equipment	149,158	65,810
Furniture, fixtures and leasehold improvements	56,343	33,760
	308,052	147,733
Less accumulated depreciation and amortization	95,841	78,364
	$212,211	$ 69,369

(9) Investment in Mutual Savings and Loan Association

Mutual is wholly owned by Wesco Financial Corporation, an 80.1% beneficially owned subsidiary of Berkshire. The investment in Mutual is reflected in other assets in the Consolidated Balance Sheets.

Summarized consolidated financial information of Mutual is as follows:

	December 31,	
Balance Sheet Data	1986	1985
Assets		
Cash and marketable securities	$253,828	$235,969
Loans receivable, net	78,613	83,425
Other assets	9,759	12,203
	$342,200	$331,597
Liabilities and Shareholder's Equity		
Savings accounts	$282,441	$269,313
Other liabilities	4,996	4,705
Total liabilities	$287,437	$274,018
Shareholder's equity, substantially restricted	54,763	57,579
	$342,200	$331,597

Earnings Statement Data	1986	1985	1984
Total revenues	$25,140	$38,798	$26,887
Net income	$ 4,684	$ 9,330	$ 6,844

The asset carrying value for the investment in Mutual was $28,178 at December 31, 1986, which figure represents Berkshire's 80.1% share of Mutual's shareholder's equity, less $15,687 negative goodwill.

(10) Investment in World Book Finance Inc.

World Book Finance, Inc. ("WBFI") was acquired by Berkshire in its acquisition of Scott Fetzer. See Note 2.

WBFI and its subsidiaries provide consumer financing, principally for *World Book* and *Kirby* products. Berkshire's investment in WBFI, $40,656 at December 31, 1986, is reflected in other assets in the Consolidated Balance Sheet.

Summarized consolidated balance sheet information of WBFI as of December 31, 1986, is as follows:

Assets	
Cash and cash equivalents	$ 43,572
Finance receivables, net of allowance for credit losses	170,289
Other assets	5,514
	$219,375
Liabilities and Shareholder's Equity	
Accounts payable and other liabilities	$ 13,472
Term debt	165,247
Equity	40,656
	$219,375

Total revenues of Scott Fetzer's financing activities were $37,233 for the period from January 6, 1986 to December 31, 1986. Net income for the period was $5,367.

Berkshire agreed with WBFI, by letter agreement dated July 1, 1986 and amended August 31, 1986, among other things, that Berkshire would (1) cause WBFI's quarterly consolidated net income to be at least a minimum amount (by payment to WBFI of a facilitating fee, if required), (2) cause WBFI to maintain capital of not less than a specified minimum amount, and (3) continue, directly or indirectly, to own all of the capital stock of WBFI. The agreement was made to accommodate the continuing financing needs of WBFI. It remains in effect, the agreement terms are not burdensome, and to date there has been no requirement thereunder for payment by Berkshire to WBFI of any facilitating fees.

(11) Income Taxes

The liability for income taxes as reflected in the Consolidated Balance Sheets represent estimates of liabilities as follows:

	Dec. 31, 1986	*Dec. 28, 1985*
Payable currently	$ 10,999	$ 97,180
Deferred, relating to unrealized appreciation of marketable securities	339,869	258,164
Deferred, arising from timing differences	63,407	26,237
	$414,275	$381,581

The Consolidated Statements of Earnings reflect charges for income taxes applicable to operating earnings and to realized investment gain as shown below.

	Applicable income taxes		
Applicable to	1986	1985	1984
Operating earnings	$ 59,152	$ 31,271	$ 16,420
Realized investment gain of consolidated companies	66,956	140,946	31,221
	$126,108	$172,217	$ 47,641
These taxes are comprised of:			
Federal	$112,313	$158,603	$ 39,128
State	12,845	13,593	8,455
Foreign	950	21	58
	$126,108	$172,217	$ 47,641
Taxes payable currently	$106,107	$137,689	$ 44,286
Deferred taxes	20,001	34,528	3,355
	$126,108	$172,217	$ 47,641

Deferred taxes represent the tax effects of timing differences as follows:

	1986	1985	1984
Deferred insurance premium acquisition costs	$ 12,778	$ 20,207	$ (872)
Structured settlements and portfolio reinsurance liabilities	2,255	7,640	3,204
Other, net	4,968	6,681	1,023
	$ 20,001	$ 34,528	$ 3,355

Charges for income taxes are reconciled in the table which follows to hypothetical amounts computed at the Federal statutory rate:

	1986	1985	1984
Net earnings including minority interest, before applicable income taxes	$414,533	$620,035	$203,031
Hypothetical amounts applicable to above computed at the Federal statutory rate (46%)	$190,685	$285,216	$ 93,394
Decreases, resulting from:			
Tax-exempt interest income	(33,112)	(16,826)	(10,992)
85% dividends received deduction relating to dividend income reported herein	(6,963)	(13,340)	(16,408)
Rate differentials relating to realized investment gains	(31,878)	(86,828)	(21,209)
State income taxes, less Federal income tax benefit	6,937	7,340	4,636
Net other differences	439	(3,345)	(1,780)
Total income taxes	$126,108	$172,217	$ 47,641

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(12) Term Debt Payable and Other Borrowings

In 1980, Berkshire issued $60,000 face amount of 12¾% debentures. These were outstanding until December 17, 1986, on which date Berkshire redeemed the entire issue. A premium of $5,355 over face amount was paid in connection with the redemption.

Remaining outstanding Berkshire term debt at December 31, 1986, amounted to $16,949. Outstanding term debt of consolidated subsidiaries at December 31, 1986 amounted to $77,974. Included is a $27,500 issue of 9½% Notes payable $2,500 annually through 1998, and $25,000 of 10⅛ Notes maturing in 1991.

Covenants of various borrowing Agreements to which the Company or its subsidiaries are parties are not materially restrictive as to their current or prospective activities.

Principal payments on term debt outstanding at December 31, 1986 are required during the succeeding five years as follows:

1987	$ 9,796
1988	5,984
1989	5,584
1990	5,536
1991	30,705

(13) Stockholders' Equity Accounts

Changes in Stockholders' Equity accounts during the most recent three years were as follows:

	Net Unrealized Appreciation	*Retained Earnings*
Balance at January 1, 1984	$483,280	$ 512,598
Increase during 1984 in unrealized appreciation included in carrying value of marketable equity securities	2,612	
Change during 1984 in deemed applicable income taxes	1,061	
Net earnings 1984		148,895
Balance at December 29, 1984	$486,953	$ 661,493
Increase during 1985 in unrealized appreciation included in carrying value of marketable equity securities	248,978	
Change during 1985 in deemed applicable income taxes	(71,217)	
Increase in minority shareholders' interest in net unrealized appreciation	(7)	
Net earnings 1985		435,815
Balance at December 28, 1985	$664,707	$1,097,308
Increase during 1986 in unrealized appreciation included in carrying value of marketable equity securities	291,804	
Change during 1986 in deemed applicable income taxes	(81,705)	
Decrease in minority shareholders' interest in net unrealized appreciation	7	
Net earnings 1986		282,361
Balance at December 31, 1986	$874,813	$1,379,669

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(14) Dividend Restrictions — Insurance Subsidiaries

Payments of dividends by Insurance Group members are restricted by insurance statutes and regulations. Payment to Berkshire by Insurance Group members of dividends in 1987 which exceed $204,350 would require approval of regulatory authorities.

Combined stockholders' equity of insurance subsidiaries, determined pursuant to statutory accounting rules (Statutory Surplus as Regards Policyholders) was $2,121,821 and $1,681,874 at December 31, 1986 and 1985, respectively. Corresponding amounts determined on the basis of generally accepted accounting principles were $1,843,169 and $1,410,976.

(15) Interest and Dividend Income

Investment income for each of the past three years was comprised of the following:

	1986	1985	1984
Dividends:			
American Broadcasting Companies	$ —	$ 1,441	$ —
Capital Cities/ABC Inc.	600	—	—
Exxon Corporation	—	5,588	2,585
GEICO Corporation	7,398	6,850	6,020
General Foods Corporation	—	7,727	10,923
The Washington Post Company	1,935	1,726	1,495
All Others	7,875	10,786	20,933
Total dividends	17,808	34,118	41,964
Interest exempt from Federal income taxes	71,982	36,579	23,896
Other interest	28,639	36,965	18,301
Interest and dividend income	$118,429	$107,662	$84,161

(16) Realized Investment Gain

A summary of net realized investment gain for each of the past three years is presented in the following table:

	1986	1985	1984
Pre-tax gain realized from special share redemption transactions	$ —	$ 19,004	$ 8,111
Pre-tax gain realized on sale of General Foods stock*	—	333,479	—
Pre-tax net gain realized on other sales of securities by consolidated companies	216,241	135,424	101,692
Applicable income taxes	(66,956)	(140,946)	(31,221)
Applicable minority interest	(411)	(7,551)	(2,035)
	148,874	339,410	76,547
Equity in after-tax gain realized by Mutual Savings and Loan Association, an unconsolidated subsidiary	2,023	3,457	2,147
Realized investment gain, net	$150,897	$342,867	$ 78,694

*Berkshire subsidiaries sold their investment in General Foods Corporation common stock in the fourth quarter of 1985 to Philip Morris Company in response to the latter's tender offer at a large premium over the then prevailing market price. Stated on an after tax basis and after deducting applicable minority interests Berkshire's gain from this single 1985 transaction amounted to $227,797 ($198.62 per share).

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(17) Pension Plans

Employees of Berkshire and its consolidated subsidiaries who meet certain eligibility requirements are covered under either employer-sponsored or union sponsored pension plans. Total pension expense charged to consolidated earnings was $3,200 in 1986, $2,469 in 1985 and $2,455 in 1984, which includes, as to certain of the plans, amortization of prior service costs over periods of 10 to 30 years. Berkshire and its subsidiaries generally fund pension costs as accrued.

A comparison of accumulated plan benefits and plan net assets as of the latest valuation dates (various dates from January 1, 1984 to December 31, 1986) for the Company's defined benefit pension plans was as follows:

Interest rate assumptions	6-10%
Actuarial present value of accumulated plan benefits:	
Vested	$ 58,513
Non-vested	4,826
Total	$ 63,339
Market value of net assets available for benefits	$105,410

Included in the total pension expense was $1,919 in 1986, $1,498 in 1985 and $1,372 in 1984, for contributions to various union-sponsored, multi-employer plans. The relative position of the Company regarding the accumulated benefits and net assets of multi-employer plans is not determinable by the Company.

(18) Quarterly Data

A summary of earnings by quarter for the past two years is presented in the following table. This information is unaudited.

1986	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Income items	$542,229	$496,307	$553,710	$604,419
Earnings before realized investment gain	39,437	28,421	33,320	30,286
Realized investment gain	46,832	94,756	2,761	6,548
Net earnings	$ 86,269	$123,177	$ 36,081	$ 36,834
Per outstanding share:				
Earnings before realized investment gain	$ 34.39	$ 24.78	$ 29.05	$ 26.40
Net earnings	75.22	107.40	31.46	32.11
1985				
Income items	$178,693	$190,116	$227,761	$343,294
Earnings before realized investment gain	22,708	18,696	18,253	33,291
Realized investment gain	22,289	48,065	37,200	235 313
Net earnings	$ 44,997	$ 66,761	$ 55,453	$268,604
Per outstanding share:				
Earnings before realized investment gain	$ 19.80	$ 16.30	$ 15.91	$ 29.03
Net earnings	39.23	58.21	48.35	234.20

Revenues and earnings from marketing of World Book products are concentrated in the first quarter. (World Book products are a significant Scott Fetzer product line.) In the fourth quarter, See's Candies normally records up to one-half of its annual revenues. Newspaper revenues and earnings also peak in the fourth quarter of the year. In the fourth quarter of 1986, adverse loss development (particularly losses on reinsurance) was recorded by the Insurance Group in amounts which tended to obscure the proportionately higher earnings in that period of the candy and newspaper businesses.

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(19) Business Segment Data

The tables below reflect data for each of the three most recent fiscal years, broken down as to business segments.

Revenues

	1986	1985	1984
Insurance	$ 931,379	$412,481	$209,523
Candy	151,861	145,103	136,053
Newspaper	114,267	107,864	101,639
Retailing of home furnishings	135,501	123,292	118,176
Encyclopedias, other reference materials	285,356	—	—
Home cleaning products	113,547	—	—
Revenues not identified with segments	444,754	151,124	163,788
	$2,176,665	$939,864	$729,179

Operating Profit Before Taxes

	1986	1985	1984
Insurance	$ 51,299	$ 50,987	$ 20,843
Candy	29,373	28,014	25,669
Newspaper	34,137	29,322	26,729
Retailing of home furnishings	17,176	12,177	14,044
Encyclopedias, other reference materials	20,534	—	—
Home cleaning products	19,586	—	—
Pre-tax operating profits not identified with segments	54,297	27,458	22,668
Corporate expenses	(2,748)	(1,725)	(1,543)
Shareholder designated contributions	(3,997)	(4,006)	(3,178)
Interest expense	(23,891)	(14,415)	(14,734)
	$195,760	$127,812	$ 90,498

Amounts are stated before deduction of any applicable minority interest. Charges or credits for depreciation and amortization of tangible and intangible assets have been taken into account. See below. Realized investment gains are not reflected.

Capital Expenditures

	1986	1985	1984
Insurance	$ 607	$ 623	$ 441
Candy	4,138	3,756	3,727
Newspaper	764	3,602	734
Retailing of home furnishings	3,771	1,665	623
Encyclopedias, other reference materials	307	—	—
Home cleaning products	1,453	—	—
Other	8,556	2,077	2,061
	$19,596	$11,723	$ 7,586

Expenditures which were part of business acquisitions are excluded.

Retailing of home furnishings	1,243	1,098	922
Encyclopedias, other reference materials	1,106	—	—
Home cleaning products	2,081	—	—
Other	15,163	2,588	2,372
	$ 25,993	$ 9,592	$ 8,764

Amortization of Intangible Assets

	1986	1985	1984
Candy	$ 975	$ 975	$ 975
Newspaper	599	599	599
Retailing of home furnishings	509	509	467
Encyclopedias, other reference materials	162	—	—
Home cleaning products	65	—	—
Other	245	(608)	(607)
	$ 2,555	$ 1,475	$ 1,434

Identifiable Assets At Year-End

	1986	1985	1984
Identified with segments:			
Insurance	$3,533,669	$2,627,957	$1,615,274
Candy	68,356	68,129	63,128
Newspaper	58,735	59,822	60,560
Retailing of home furnishings	64,946	64,617	60,367
Encyclopedias, other reference materials	78,893	—	—
Home cleaning products	35,752	—	—
Other	357,608	49,500	56,940
	4,196,459	2,870,025	1,856,269
Not identified with segments:			
Investment in unconsolidated subsidiaries	70,649	31,027	33,235
Corporate cash and marketable securities of parent and non-insurance subsidiaries	174,547	279,666	145,699
	$4,441,655	$3,180,718	$2,035,203

The totals set out above include amounts representing unamortized goodwill, as follows:

	1986	1985	1984
Candy	$ 32,548	$ 33,523	$ 34,497
Newspaper	21,708	22,307	22,907
Retailing of home furnishings	18,789	19,298	19,807
Encyclopedias, other reference materials	6,333	—	—
Home cleaning products	2,529	—	—
Other	45,050	41	58
	$ 126,957	$ 75,169	$ 77,269

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(19) Business Segment Data (Continued)

Revenues of the Insurance Segment

	1986	1985	1984
Premiums written	$1,009,430	$497,400	$133,558
Premiums earned:			
Specialized auto and general liability	385,737	123,410	64,003
Workers' Compensation*	18,601	17,715	22,665
Home State multiple lines	58,779	43,208	32,598
Subtotal — excludes reinsurance assumed	463,117	184,333	119,266
Reinsurance	26,595	12,616	16,066
Major quota-share reinsurance	317,790	70,261	—
Structured settlements and portfolio reinsurance	16,382	49,849	4,910
Total premiums earned	823,884	317,059	140,242
Investment income	107,495	95,422	69,281
	$ 931,379	$412,481	$209,523

*Workers' Compensation coverage written by the Home State Companies, as part of their multiple line business, is not disaggregated from their total earned premiums.

Insurance Segment Operating Profit Before Taxes

	1986	1985	1984
Underwriting gain (loss):			
Specialized auto and general liability	$ 10,548	$ (2,950)	$(16,049)
Workers' Compensation	(3,891)	(2,406)	(12,703)
Home State multiple lines	(3,119)	(2,791)	(4,101)
Subtotal — excludes reinsurance assumed	3,538	(8,147)	(32,853)
Reinsurance	(31,406)	(19,712)	(12,560)
Major quota-share reinsurance	(17,949)	(10,261)	—
Structured settlements and portfolio reinsurance	(10,027)	(6,110)	(2,647)
Total underwriting (loss)	(55,844)	(44,230)	(48,060)
Net Investment income	107,143	95,217	68,903
	$ 51,299	$ 50,987	$ 20,843

PARENT COMPANY ONLY — SUMMARIZED FINANCIAL STATEMENTS

(dollars in thousands)

These summarized financial statements should be read in conjunction with the Consolidated Financial Statements of Berkshire Hathaway Inc. and consolidated subsidiaries and the notes thereto.

Balance Sheets

Assets	*Dec. 31, 1986*	*Dec. 28, 1985*
Cash and invested cash	$ 4,151	$ 2,724
Investment in subsidiaries (including unrealized appreciation of marketable equity securities owned by insurance subsidiaries, net of taxes, amounting to $874,813 at Dec. 31, 1986 and $664,707 at Dec. 28, 1985)	2,398,873	2,055,879
Other assets	2,102	5,734
	$2,405,126	$2,064,337
Liabilities and Stockholders' Equity		
Accounts payable and accrued expenses	$ 2,244	$ 7,020
Term debt and other borrowings	16,949	79,261
Income taxes	8,136	92,726
	27,329	179,007
Stockholders' equity (See Consolidated Balance Sheets)	2,377,797	1,885,330
	$2,405,126	$2,064,337

Statements of Earnings

Income items:	*1986*	*1985*	*1984*
From subsidiaries:			
Interest	$ 299	$ 507	$ 470
Dividends	427,546	86,094	24,732
Undistributed earnings	(134,773)	355,396	121,990
	293,072	441,997	147,192
Interest and dividends — other investments	1,263	1,276	3,626
Other income	4	2,904	11,292
Income tax credit	8,207	4,529	2,190
	302,546	450,706	164,300
Cost and expense items:			
Corporate administration	2,748	1,725	1,544
Shareholder designated contributions*	867	805	808
Textile business expenses**	1,474	1,850	2,279
Interest expense	15,096	10,511	10,774
	20,185	14,891	15,405
Net earnings	$282,361	$435,815	$148,895

**Additional shareholder designated contributions were made by wholly-owned subsidiaries.*

***The parent company operated a textile products manufacturing and marketing business that was discontinued at the end of 1985. Gross profit from sale of textile products is reflected above in other income for 1984 and 1985. Textile business expenses reflected for 1984 and 1985 represent administrative and selling expenses of the business. Textile business expenses for 1986 represents costs associated with abandonment of the business, net of rental income received from leasing to unrelated persons of portions of the real properties previously used in the business.*

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Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

Note 19 to the Consolidated Financial Statements (the "Segment Note"), at pages 41 to 43, should be referenced in connection with this discussion.

Revenues

Total consolidated revenues in 1986 were in excess of $2.1 billion, compared to approximately $940 million in 1985 and $729 million in 1984. "Sales and service revenues" — sales recorded for non-insurance business segments — increased from $509 million in 1985 to over $1.2 billion in 1986. Berkshire's acquisition on January 6 1986 of Scott Fetzer resulted in a notable increase in scope and diversity of activities conducted by Berkshire subsidiaries. Of the total 1986 sales and service revenues, Scott Fetzer operations contributed $677 million. Also, on June 3, 1986, Berkshire purchased an 84% interest in the business of The Fechheimer Brothers Company, and approximately $41 million of Berkshire's 1986 sales revenues reflect those generated by this business during the last seven months of the year.

Exceptional growth also occurred during 1986, as well as in 1985, in premiums earned by the Berkshire Hathaway Insurance Group. Major quota share reinsurance contracts that were not in force two years ago contributed $313 million to 1986 earned premiums. "Special large risks" (annual premiums per risk in excess of $1 million), underwritten by a department new to the Group in 1985, contributed $71 million to 1986 earned premiums. Other earned premium increases reflect significantly higher average premium rates applicable to policies issued in a tight market to a greater number of risks. The tight market and higher premium rates were features of the property/casualty insurance industry in both 1985 and 1986.

Earnings

The Segment Note reflects, among other information, operating profit before taxes for each of the past three years for each of the significant Berkshire business segments. A large proportion of the Insurance Group's investment income is free of income taxes. A capital gains tax rate applies to realized securities gains. After-tax net earnings are disaggregated in the following table, thus reflecting results after giving effect to the different rates of income tax that apply to different categories of income.

	After-Tax Earnings (Costs)		
	000s Omitted		
	1986	*1985*	*1984*
Insurance	$ 66,576	$ 56,147	$ 36,104
Manufacturing, merchandising and services	80,743	47,184	44,098
Interest and financing costs	(12,213)	(7,288)	(7,452)
Other unallocated corporate costs	(3,642)	(3,095)	(2,549)
Earnings before realized investment gain	131,464	92,948	70,201
Realized investment gain	150,897	342,867	78,694
Net earnings	$282,361	$435,815	$148,895

Berkshire's insurance businesses in each of the past three years generated a net tax benefit in Berkshire's consolidated Federal income tax return, so that their after-tax net earnings as shown above exceeds their operating profit before taxes as shown in the Segment Note.

A summary of the underwriting results of the Berkshire Hathaway Insurance Group is presented below, on the basis of generally accepted accounting principles ("GAAP"), for the past three years, with dollars in thousands:

	1986		1985		1984	
	Amount	%	Amount	%	Amount	%
Premiums written	$1,009,430		$497,400		$133,558	
Premiums earned	823,884	100.0	317,059	100.0	140,242	100.0
Losses and loss expenses	655,758	79.6	280,249	88.4	141,550	100.9
Underwriting expenses	223,970	27.2	81,040	25.6	46,752	33.4
Total losses and expenses	879,728	106.8	361,289	114.0	188,302	134.3
Underwriting loss — pre-tax	(55,844)		(44,230)		(48,060)	
Applicable income tax credit	25,688		20,346		22,105	
Applicable minority interest	292		315		—	
After-tax loss	$ (29,864)		$ (23,569)		$ (25,955)	

The percentage figures shown in the above table representing the ratio of total losses and expenses to premiums earned (hereafter, the "loss and expense ratio") is comparable but not identical to the "combined ratio" that is computed for companies in the industry based on data assembled for statutory reporting purposes. Underwriting results, computed on a GAAP basis, are profitable to the extent that the loss and expense ratio is less than 100% and unprofitable to the extent that it exceeds 100%.

Summaries of aggregate loss and loss expense data for the Berkshire Hathaway Insurance Group for the past three years are shown in the following table.

	000s Omitted		
	1986	1985	1984
Unpaid losses and loss expense at beginning of year	$411,305	$243,298	$212,706
Incurred losses recorded:			
Current year occurrences	593,017	206,194	116,441
All prior years' occurrences	37,014	19,505	17,770
Structured settlement and portfolio reinsurance obligations	25,727	54,550	7,339
	655,758	280,249	141,550
Payments with respect to:			
Current year occurrences	96,797	40,574	40,820
All prior years' occurrences	107,167	74,341	77,216
Structured settlement and portfolio reinsurance obligations	2,871	(2,673)*	(7,078)*
	206,835	112,242	110,958
Unpaid losses and loss expense at end of year	$860,228	$411,305	$243,298

*Net recoveries

Adverse loss development is represented by the figures for incurred losses captioned "All prior years' occurrences" ($37,014,000 for 1986, $19,505,000 for 1985, and $17,770,000 for 1984). These figures represent increases in the given year to the estimates of prior years' loss occurrences, based on information that came to light in that given year with respect to such prior occurrences. If the prior year-end estimation processes would have been perfect, all of the costs related to prior years' occurrences would have been charged to prior years' results. Thus, the amount of "development" recorded in a given year is an indication of the estimation error that resulted when the prior year-end liability for unpaid losses was established. It is only an indicator of the degree of that error, because even though one additional year's hindsight is employed in making the revised estimate, additional information will become available and events will subsequently occur that influence the actual loss amounts ultimately incurred with respect to the prior years' occurrences. It takes many years to determine the precise amount of estimation error that existed in an original estimate. One-year developments, as presented above, have the advantage of revealing the effect on reported income of any given year of the estimation error recognized in that year.

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Aggregation of underwriting data of the Berkshire Hathaway Insurance Group serves a purpose in any broad analysis of Berkshire's total operations. However, analysis and discussion that deals only with Berkshire's insurance operations requires further disaggregation of Insurance Group data. Various sub-groupings are possible, one of which is reflected in the last two tables of the Segment Note appearing at page 43. That breakdown aligns with management's view of the components of Berkshire's insurance business. The balance of this discussion centers around that breakdown, summarized as to (i) business other than reinsurance assumed, and (ii) reinsurance assumed.

Insurance Operations Excluding Reinsurance Assumed Business

A summary follows of the combined underwriting results of the Berkshire Hathaway Insurance Group, excluding reinsurance assumed business. Dollars are in thousands.

	1986		1985		1984	
	Amount	%	Amount	%	Amount	%
Premiums written	$594,607		$269,057		$118,090	
Premiums earned	463,117	100.0	184,333	100.0	119,266	100.0
Losses and loss expenses	347,468	75.0	140,029	76.0	110,491	92.6
Underwriting expenses	112,111	24.2	52,451	28.4	41,628	34.9
Total losses and expenses	459,579	99.2	192,480	104.4	152,119	127.5
Underwriting gain (loss) — pre-tax	3,538		(8,147)		(32,853)	
Applicable income tax credit (expense)	(1,628)		3,748		15,110	
After-tax gain (loss)	$ 1,910		$ (4,399)		$ (17,743)	

Decreases have occurred in each of the past two years in the ratio of incurred underwriting expenses to premiums earned. To some extent this is attributable to the nature of some administrative costs which do not vary proportionately with changes in volume. But, cost control measures also contributed. Also, underwriting expenses are a much lower percentage of premiums for special large risk coverages than is true for other of the Group's direct business. This caused a decrease between 1985 and 1986 in the expense ratio inasmuch as the special large risks earned premiums made up 15% of 1986 vs. only 4% of 1985 earned premiums shown above.

Summarized below is loss and loss expense data for this business.

	000s Omitted		
	1986	1985	1984
Unpaid losses and loss expense at beginning of year	$209,236	$164,776	$150,804
Incurred losses recorded:			
Current year occurrences	331,463	139,966	102,386
All prior years' occurrences	16,005	63	8,105
	347,468	140,029	110,491
Payments with respect to:			
Current year occurrences	53,086	35,419	36,608
All prior years' occurrences	74,113	60,150	59,911
	127,199	95,569	96,519
Unpaid losses and loss expense at end of year	$429,505	$209,236	$164,776

Adverse loss development of $16,005,000 in 1986 added about 3.5 percentage points to the 1986 loss and expense ratio bringing it up to 75 in total. The adverse development is a higher ratio (7.6%) of beginning of year reserves. Because the reserve for losses is estimated, some development, either positive or negative, will always occur, but 7.6 points is outside of the more respectable plus-or-minus 5% range.

The combined underwriting results of the Berkshire Hathaway Insurance Group for subsegments of the business involving reinsurance assumed, other than structured settlements and portfolio reinsurance, are summarized in the following table, with dollars in thousands.

	1986		1985		1984	
	Amount	%	*Amount*	%	*Amount*	%
Premiums written	$398,446		$178,502		$ 10,542	
Premiums earned	344,385	100.0	82,877	100.0	16,066	100.0
Losses and loss expenses	282,563	82.0	85,670	103.4	23,720	147.6
Underwriting expenses	111,177	32.3	27,180	32.8	4,906	30.5
Total losses and expenses	393,740	114.3	112,850	136.2	28,626	178.1
Underwriting loss — pre-tax	(49,355)		(29,973)		(12,560)	
Applicable income tax credit	22,703		13,788		5,777	
Applicable minority interest	292		315		—	
After-tax loss	$ (26,360)		$ (15,870)		$ (6,783)	

Summarized below is loss and loss expense data with respect to the above summarized assumed business for the past three years.

	000s Omitted		
	1986	*1985*	*1984*
Unpaid losses and loss expense at beginning of year	$114,191	$ 47,867	$ 45,664
Incurred losses recorded:			
Current year occurrences	261,554	66,228	14,055
All prior years' occurrences	21,009	19,442	9,665
	282,563	85,670	23,720
Payments with respect to:			
Current year occurrences	43,711	5,155	4,212
All prior years' occurrences	33,054	14,191	17,305
	76,765	19,346	21,517
Unpaid losses and loss expense at end of year	$319,989	$114,191	$ 47,867

The above data includes the significant amounts that resulted from major quota-share reinsurance agreements, one involving 7% of the post 8/31/85 business of Fireman's Fund Insurance companies and another, first effective in 1986, involving a sizable part of the business of another major insurance company. No adverse loss development has been recorded by the Group with respect to those contracts. Instead, the adverse development reflected above relates to several smaller contracts which have developed unfavorably for the Group. Approximately $19 million of the 1986 adverse development was recorded in the fourth quarter of the year.

Comparable summaries of the structured settlements and portfolio subsegment of the reinsurance business are not informative, since different ratio analyses are applicable, depending on the varying nature of the several different arrangements included in this very specialized area. Reference is made to the Segment Note which reflects this subsegment's premium and pre-tax loss information.

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Berkshire's non-insurance business activities became more diverse in 1986. Businesses that were acquired in 1986, discussed elsewhere herein, were largely responsible for the significant difference between 1986 and 1985 aggregate results of these activities.

Interest and Dividend Income

This income is largely earned by the Insurance Group. However, Wesco, certain other subsidiaries and, from time to time, Berkshire also have investments in securities. The makeup of the consolidated total interest and dividend income is shown in Note 15 to the consolidated financial statements. It is summarized and reduced to after-tax earnings, in thousands of dollars, in the following table.

	Before Taxes	*Applicable income taxes*	*Applicable minority interest*	*Net earnings*
1986	$118,429	$14,023	$2,333	$102,073
1985	107,662	19,865	1,593	86,204
1984	84,161	11,802	1,342	71,017

Tax exempt interest income has increased significantly in each of the past two years, because investments in State and Municipal obligations have increased substantially.

Interest and Financing Costs

Interest and financing costs increased approximately $9.5 million, before income tax effect, in 1986 over 1985. Berkshire called for prepayment on December 17, 1986 its $60 million 12¾% debentures, scheduled to mature in the years 1991 through 2005. Pursuant to the terms of the Indenture under which these obligations were issued in 1980, an 8.925% call premium, amounting to $5,355,000 was paid in connection with the early redemption.

Also, interest on term debt of Scott Fetzer to which its assets were subject when acquired by Berkshire in January 1986 amounted to approximately $4.4 million in 1986.

Realized Investment Gain

Realized investment gain has been an element of Berkshire's net earnings for each of the past several years. The amount of this gain — recorded by Berkshire when appreciated securities are sold — tends to fluctuate significantly from period to period The varying effect upon Berkshire's consolidated net earnings is evident on the face of the consolidated statements of earnings. The amount of realized investment gain for any period has no predictive value, and variations in amount from period to period have no practical analytical value, given the pre-existence of substantial unrealized price appreciation in Berkshire's consolidated investment portfolio.

Liquidity and Capital Resources

Berkshire's consolidated balance sheet as of December 31, 1986 reflects continuing capital strength and liquidity. Berkshire shareholders' equity has increased from $1,119,193,000 at December 31, 1983 to $2,377,797,000 at December 31, 1986. In that three-year period, realized and unrealized securities gains increased equity capital by approximately $964 million, and reinvested earnings, other than realized securities gains, were approximately $295 million. Berkshire's liabilities have also increased. The total consolidated liabilities reflected on Berkshire's December 31, 1983 consolidated balance sheet were about $700 million. Three years later, at December 31, 1986, the corresponding total is just over $2 billion. The increase does not reflect additional liability for borrowed funds. To the contrary, consolidated term debt, approximately $129 million three years ago, was reduced to approximately $95 million at the end of 1986. The increase in total liabilities largely arose from increased funds held for the benefit of Berkshire Hathaway Insurance Group policyholders — unpaid losses, loss adjustment expenses and unearned premiums of Berkshire's insurance subsidiaries. Their total increased approximately $1 billion in the most recent three-year period. Berkshire's financial policies are directed so as to continuously provide wide margins of safety, in the form of significant financial strength and ample liquidity, in support of the Company's financial obligations.

The 1986 Annual Report of Wesco Financial Corporation included the following letter to Wesco stockholders from the Chairman of the Company.

WESCO FINANCIAL CORPORATION
LETTER TO SHAREHOLDERS

To Our Shareholders:

Consolidated "normal" operating income (i.e., before all unusual operating income and all net gains from sales of securities) for the calendar year 1986 increased to $11,934,000 ($1.68 per share) from $8,347,000 ($1.17 per share) in the previous year.

Consolidated net income (i.e., after unusual operating income and all net gains from sales of securities) decreased to $16,524,000 ($2.32 per share) from $51,541,000 ($7.24 per share) in the previous year.

A highly unusual capital gain, of a not-likely-to-recur type, from disposition of General Foods stock caused most of the net income in 1985. The table below gives particulars.

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses, and Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged in the reinsurance business. Consolidated net income for the two years just ended breaks down as follows (in 000s except for per-share amounts)[1]:

	Year Ended			
	December 31, 1986		December 31, 1985	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	$ 2,159	$ .30	$ 3,342	$ .47
Precision Steel businesses	1,701	.24	2,010	.28
Wesco-Financial Insurance business—				
Underwriting	(1,469)	(.21)	(1,584)	(.22)
Investment activity	8,084	1.14	1,225	.17
	6,615	.93	(359)	(.05)
All other "normal" net operating income[2]	1,459	.21	3,354	.47
	11,934	1.68	8,347	1.17
Fluctuation in market value of GNMA futures contract	—	—	1,671	.24
Net gains on sales of securities[3]	4,590	.64	41,523	5.83
Wesco consolidated net income	$16,524	$2.32	$51,541	$7.24

[1] All figures are net of income taxes.

[2] After deduction of interest and other corporate expenses. Income was from ownership of the Mutual Savings headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries.

[3] The 1985 figure includes a $34,363,000 ($4.83 per share) gain realized by Wesco on the sale of its General Foods Corporation common stock to Philip Morris Company in connection with the latter's publicly announced tender offer.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The supplementary breakdown is furnished because it is considered useful to shareholders.

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Mutual Savings

Mutual Savings' "normal" net operating income of $2,159,000 in 1986 represented a decrease of 35% from the $3,342,000 figure the previous year.

Separate balance sheets of Mutual Savings at yearend 1985 and 1986 are set forth at the end of this annual report. They show (1) total savings accounts rising to $282 million from $269 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (probably the highest for any mature U.S. savings and loan association), (3) a substantial portion of savings account liabilities offset by cash equivalents and marketable securities, (4) a loan portfolio (mostly real estate mortgages) of about $79 million at the end of 1986, down 6% from the $83 million at the end of 1985, and (5) favorable effects of securities gains, which caused net worth to decline only $3 million in 1986 despite payment of a dividend of $7.5 million to the parent corporation.

The loan portfolio at the end of 1986, although containing almost no risk of loss from defaults, bore an average interest rate of only 7.48%, probably the lowest for any U.S. savings and loan association and about equal to the average interest rate which now must be paid to hold savings accounts. This, of course, leaves no net interest margin to cover operating costs. However, the unrealized depreciation in the loan portfolio is now more than offset by unrealized appreciation in Mutual Savings' interest-bearing securities and preferred stocks. Such unrealized appreciation at December 31, 1986 was about $17 million.

As pointed out in footnote 14 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($54.8 million at December 31, 1986) overstates the amount realizable, after taxes, from sale or liquidation at book value. If all Mutual Savings' assets, net of liabilities, were to be sold, even pursuant to a plan of complete liquidation, for the $54.8 million in book value reported under applicable accounting convention, the parent corporation would receive much less than $54.8 million after substantial income taxation imposed because about $47 million of what is designated shareholders' equity for accounting purposes is considered bad debt reserves for most tax purposes.

There is, however, in Mutual Savings, not only a buried plus value in unrealized appreciation of securities, but also a buried plus value in real estate. The foreclosed property on hand (mostly 22 largely oceanfront acres in Santa Barbara) has become worth over a long holding period much more than its $1.6 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 11 years in the course of administration of land-use laws. But we are optimistic that delay will end in 1987 and that the Santa Barbara and Montecito communities will be very pleased with development into 32 houses interspersed with large open areas. Mutual Savings plans to make the development first rate in every respect, and unique in the quality of its landscaping.

The buried plus value in real estate is limited by the small number of houses allowed (32) and by the fact that only a minority of such houses (12) will have any significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, and landscaping. And, most important of all, various charges and burdens imposed by governmental bodies will drastically reduce our potential recovery from what it would have been had the zoning and development climate of the early 1970s continued into 1987.

Balancing all merits and demerits, Mutual Savings, as it has been managed under present conditions by the writer and others, continues to be a mediocre business from the shareholders' point of view. Mutual Savings' good points are: (1) high asset quality and sound balance sheet; (2) a maturity match of interest-bearing assets and liabilities which makes risk of insolvency near zero, whatever happens to interest rates; and (3) a deserved reputation for high quality service to account holders, achieved at below-average cost to the institution in an efficient one-large-office operation, as distinguished from a many-small-branch-offices operation. Mutual Savings' bad points are: (1) all recent growth in savings accounts, considered on an incremental-effects basis, has been loss business because interest and other costs incurred exceed income obtained by employing proceeds in short-term interest-bearing assets; (2) a burdensome position under the FSLIC account-insurance system causes payments of ever-higher amounts into the system to help bail out more venturesome savings and loan associations which become insolvent, with the payments being required despite the fact that Mutual Savings imposes almost no risk on FSLIC; (3) "normal" net operating income is below an acceptable rate of return on present book value of shareholders' equity, with such return reaching an acceptable level over recent years only with help from securities gains and other unusual items; (4) it would not be easy to leave the savings and loan business, should this course of action ever be desired, without a large income tax burden of a type not applied to corporations other than savings and loan associations; (5) as explained in last year's annual report, the regulatory structure of the savings and loan business creates a competitive situation in which it is hard to make respectable profits through careful operations; and (6) management has not yet found an acceptable remedy for any of the previously listed bad points, despite years of trying.

Moreover, comparisons of post-1984 financial results for Mutual Savings with results for many other and more typical savings and loan associations in California continue to leave Mutual Savings looking inferior, to put it mildly. As interest rates went down these other associations, which have greater financial leverage and operated less fearfully than Mutual Savings during former high-interest periods, came to have loan and investment portfolios which (1) now are worth more on average than book value and (2) now produce a high return on book value of shareholders' equity, after deduction of operating expenses and interest to account holders at present rates. Any Wesco shareholder who thinks Mutual Savings has any expertise in predicting and profiting from interest rate changes can look at the 1985-1986 record and despair.

Despite the fact that some other savings and loan associations did much better after 1984 than Mutual Savings, and are now much better poised to report good figures for 1987, we plan to continue operating only in ways acceptable in our own judgment, anticipating as a consequence widely fluctuating and sometimes inadequate returns. In the future, however, Mutual Savings will make and purchase more loans. Now that Mutual Savings' old mortgage loans have declined in amount and increased in market value (the market value increase being caused both by a decline in generally prevailing interest rates and by a shortening of remaining loan life), new loans will be added as seems wise, with a target that at least 60% of assets be in housing-related loans. New direct loans aggregating $9 million were made in 1986, all adjustable rate mortgages with no cap on future interest rate changes but with an extremely low "spread" for the lender. In recent months the total of all loans on hand has risen as new loans made exceeded principal payoffs on old loans.

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With assets not employed in direct real-estate lending, Mutual Savings continues not only to make payments to FSLIC far in excess of fair charges for risks imposed on FSLIC but also to employ a large part of total assets in short-term loans to the Federal Home Loan Bank. These practices are pro-social but will continue to reduce profits.

Mutual Savings also continues to support the Federal Home Loan Bank Board in its efforts to change the present rules of the savings and loan business to augment average soundness of FSLIC-insured associations and prevent recurrence of widespread insolvencies like those now bedevilling the industry.

Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, the company had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $1,701,000 to "normal" net operating income in 1986, down 15% compared with $2,010,000 in 1985. The decrease in 1986 profit occurred in spite of increased revenues (up 2% to $52,304,000).

Under the skilled leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $10,172,000 to 1986 sales at a profit margin higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using available liquid assets.

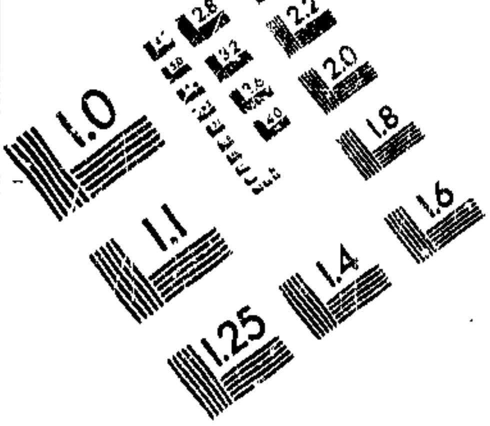
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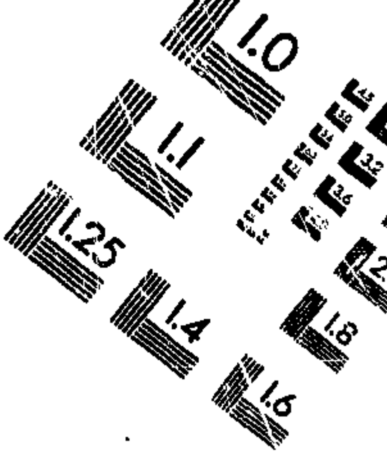
IMAGE EVALUATION TEST TARGET (MT-3)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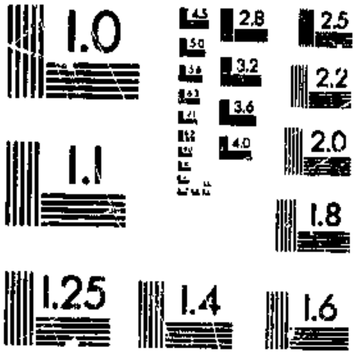
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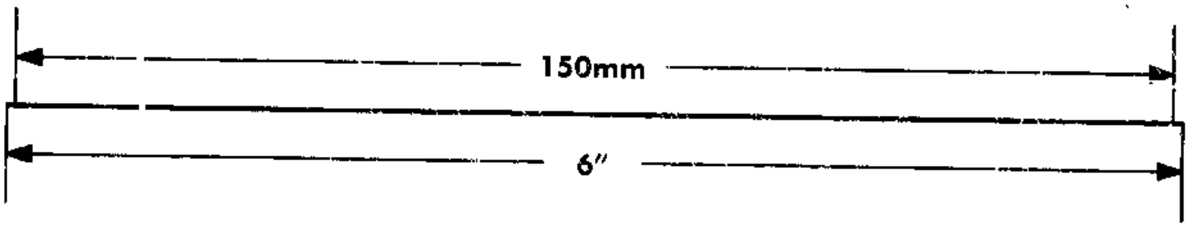

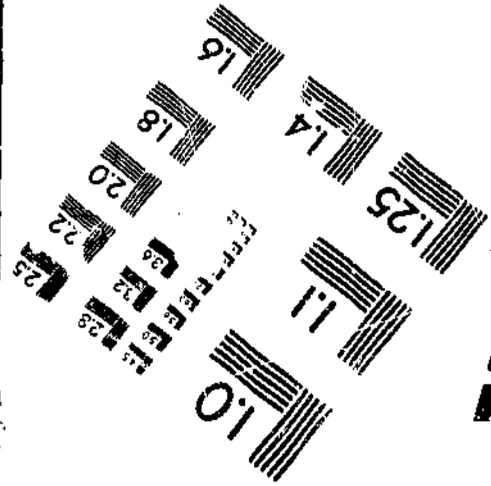
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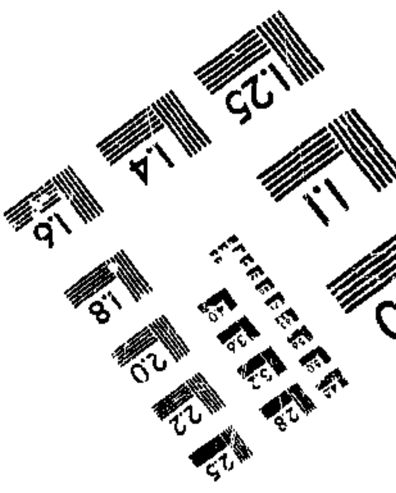
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Wesco-Financial Insurance Company

A new business was added to the Wesco group in 1985, in co-venture with Wesco's 80% owner and ultimate parent corporation, Berkshire Hathaway Inc.

With the enthusiastic approval of all Wesco's directors, including substantial Wesco shareholders in the Peters and Caspers families, without whose approval such action would not have been taken, Wesco in 1985 invested $45 million in cash equivalents in a newly organized, wholly owned, Nebraska-chartered insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $36.2 million was invested in January 1986.

The new subsidiary, Wes-FIC, has reinsured, through another Berkshire Hathaway insurance company subsidiary as intermediary-without-profit, 2% of the entire book of insurance business of the long-established Fireman's Fund Corp. (listed on the NYSE). Wes-FIC thereby assumed the benefits and burdens of Fireman's Fund's prices, costs and losses under a contract covering all insurance premiums earned by Fireman's Fund during a four-year period commencing September 1, 1985. The arrangement puts Wes-FIC in almost exactly the position it would have been in if it, instead of Fireman's Fund, had directly written 2% of the business. Differences in results should occur only from the investment side of insurance, as Wes-FIC, instead of Fireman's Fund, invests funds from "float" generated. Wes-FIC's share of premiums earned in 1986 exceeded $67 million.

Wes-FIC's separate financial statements, covering the brief period of its existence, September 1, 1985, to December 31, 1986, are included on page 30 of this Annual Report, and show that Wes-FIC's net income for 1986 was $6,967,000 versus a small deficit ($359,000) for its first 4 months of operation in 1985. The 1986 net income figure included securities gains, net of income taxes, of $352,000.

It is in the nature of even the finest casualty insurance businesses that in keeping their accounts they must estimate and deduct all future costs and losses from premiums already earned. Uncertainties inherent in this undertaking make financial statements more mere "best honest guesses" than is typically the case with accounts of non-insurance-writing corporations. And the reinsurance portion of the casualty insurance business, because it contains one or more extra links in the loss-reporting chain, usually creates more accounting uncertainty than the non-reinsurance portion. Wesco shareholders should remain aware, not only of the inherent imperfections of Wes-FIC's accounting, but also of the inherent cyclicality of its business.

However, Wesco hopes for: (1) a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract, and (2) possible future reinsurance contracts with other insurers.

We very much like our association with Fireman's Fund, a real class operation, and with Jack Byrne, its CEO, who displayed great integrity, intelligence and vigor in returning GEICO Corporation to glory before he took his present position.

With assets not employed in direct real-estate lending, Mutual Savings continues not only to make payments to FSLIC far in excess of fair charges for risks imposed on FSLIC but also to employ a large part of total assets in short-term loans to the Federal Home Loan Bank. These practices are pro-social but will continue to reduce profits.

Mutual Savings also continues to support the Federal Home Loan Bank Board in its efforts to change the present rules of the savings and loan business to augment average soundness of FSLIC-insured associations and prevent recurrence of widespread insolvencies like those now bedevilling the industry.

Precision Steel

Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, was acquired for approximately $15 million on February 28, 1979. The price was roughly book value for a company which carried its inventories on a conservative LIFO accounting basis and which contained significant cash balances. More important, the company had reached its position from a modest beginning through maintenance of sound, customer-oriented business values inculcated over a long time by a gifted founder and his successors. Precision Steel owns a well-established steel service center business and a subsidiary engaged in the manufacture and distribution of tool room supplies and other specialty metal products.

Precision Steel's businesses contributed $1,701,000 to "normal" net operating income in 1986, down 15% compared with $2,010,000 in 1985. The decrease in 1986 profit occurred in spite of increased revenues (up 2% to $52,304,000).

Under the skilled leadership of David Hillstrom, Precision Steel's businesses are now quite satisfactory, taking into account the financial leverage put into Wesco's consolidated picture incident to their acquisition.

Shortly after Wesco's purchase of Precision Steel, a substantial physical expansion of steel warehousing facilities was authorized, involving a new building in Charlotte, North Carolina. The new building and the whole North Carolina operation are now very successful, contributing $10,172,000 to 1986 sales at a profit margin higher than has prevailed in the long-established Chicago headquarters' facility.

Precision Steel's businesses, despite their mundane nomenclature, are steps advanced on the quality scale from mere commodity-type businesses. Many customers of Precision Steel, needing dependable supply on short notice of specialized grades of high-quality, cold-rolled strip steel, reasonable prices, technical excellence in cutting to order, and remembrance when supplies are short, rightly believe that they have no fully comparable alternative in Precision Steel's market area. Indeed, many customers at locations remote from Chicago and Charlotte (for instance, Los Angeles) seek out Precision Steel's service.

Wesco remains interested in logical expansion of Precision Steel's businesses, using available liquid assets.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, decreased to $1,459,000 in 1986 from $3,354,000 in 1985. Sources were (1) rents ($2,229,000 gross, excluding rent from Mutual Savings) from Wesco's Pasadena office building block (predominantly leased to outsiders although Mutual Savings is the ground floor tenant) and (2) interest and dividends from cash equivalents and marketable securities held by Precision Steel and its subsidiaries and at the parent company level. The great decrease in interest and dividends received in this "other income" category was caused by the transfer of assets to Wes-FIC, where income is now classified as insurance income.

Net Gains on Sales of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, decreased to $4,590,000 in 1986 from $41,523,000 in 1985.

Bowery Savings Bank

In 1985 Wesco, in another co-venture with its parent corporation, approved by Wesco's directors in the same manner as the Wes-FIC co-venture, joined a group which invested $100,000,000 cash in a newly organized, New York-chartered savings bank. The new bank then took over the name, assets and liabilities of the insolvent Bowery Savings Bank in the city of New York. The takeover received (1) much needed assistance from FDIC, the federal agency, akin to FSLIC, which insures deposits in banks, and (2) the blessing of New York bank regulators. Wesco invested $9,000,000, other Berkshire Hathaway subsidiaries invested $12,384,000, and other unrelated investors invested the balance of the $100,000,000.

The terms of the FDIC assistance, which include income-assistance payments over many years to the newly organized bank, are extremely complex but can be fairly summarized as far from adequate to assure that the investors will make a profit. This is as it should be when $100 million buys a highly-leveraged residual equity position in a $5 billion bank, albeit one with many sick assets.

Any minority-position investment with such extreme financial leverage (in effect buying with a 2% down payment), involving a troubled company in a demanding environment, can fairly be called a venture-capital type investment for Wesco. In our judgment, the prospect for gain justified the risk of loss.

This investment continues to be carried at cost in Wesco's accompanying financial statements, and we continue in guarded optimism regarding our position.

Consolidated Balance Sheet and Related Discussion

Wesco's consolidated balance sheet (1) retains a strength befitting a company whose consolidated net worth supports large outstanding promises to others and (2) reflects a continuing slow pace of acquisition of additional businesses because few are found available, despite constant search, at prices deemed rational from the standpoint of Wesco shareholders.

As indicated in Note 3 to the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1986 by about $13 million, up modestly from about $5 million one year earlier. The consolidated aggregate market value of all marketable securities, including bonds and other fixed-income securities, exceeded aggregate carrying value by about $23 million. As earlier noted, about $17 million of this unrealized appreciation lies within the savings and loan subsidiary.

Wesco's Pasadena real estate, a full block (containing (1) about 125,000 first class net rentable square feet, including Mutual Savings' space, in a modern office building, plus (2) an additional net rentable 34,000 square feet of economically marginal space in old buildings requiring expensive improvement), has a market value substantially in excess of carrying value, demonstrated by (1) mortgage debt ($4,940,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($3,091,000) in Wesco's balance sheet at December 31, 1986, and (2) substantial current net cash flow (about $1 million per year) to Wesco after debt service on the mortgage. The modern office building is 96% rented, despite a glut of vacant office space in Pasadena. We charge just-below-standard rents and run the building as a sort of first-class club for tenants we admire. With these practices, a prime location and superior parking facilities, we anticipate future increases in cash flow, but at no better rate than the rate of inflation.

Wesco remains in a prudent position when total debt is compared to total shareholders' equity and total liquid assets. Wesco's practice has been to do a certain amount of long-term borrowing in advance of specific need, in order to have maximum financial flexibility to face both hazards and opportunities.

It is expected that the balance sheet strength of the consolidated enterprise will in due course be used in one or more business extensions. The extension activity, however, requires patience, as suitable opportunities are not always present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and reinsurance subsidiaries and those held temporarily elsewhere pending sale to fund business extension, tend to be concentrated in very few places. Through this practice of concentration of investments, better understanding is sought with respect to the few decisions made.

The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 19% in 1984-86, was dependent to a very large extent on securities gains, irregular by nature. This recent ratio is almost certain to continue to decline, probably sharply, as it did in 1986. Neither possible future acquisitions of other businesses nor possible future securities gains appear likely to help much in the short term. The business acquisition game continues to be crowded with optimistic players who usually force prices for low-leverage acquirers like Wesco to levels where return-on-investment prospects are modest. And future securities gains are likely to prove harder to come by for very simple reasons. Because securities generally traded lower several years ago than they do now, relative to the intrinsic values of the businesses represented by the securities, creating more obviously sound investments then than now, and because prospects for above-average returns tend to go down as assets managed go up, it is now, early in 1987, even easier than it was early in 1986, to predict less desirable future results. It is also easy for any sophisticated Wesco shareholder, reviewing either (i) this virtual reprint of last year's letter or (ii) Wesco's marketable securities disclosed herein, to diagnose (correctly) that the decision-makers are now even more dry of good ideas than they were a year earlier.

The considerable, and higher than normal, liquidity of Wesco's consolidated financial position as this is written does not result from our forecast that business conditions are about to worsen, or that interest rates are about to rise, or that common stock prices are about to fall. Wesco's condition results, instead, from our simply not finding opportunities for more aggressive use of capital with which we are comfortable.

Wesco continues to try more to profit from always remembering the obvious than from grasping the esoteric (including much modern "strategic planning" and "portfolio theory"). Such an approach, while it has worked fairly well on average in the past and will probably work fairly well over the long-term future, is bound to encounter periods of dullness and disadvantage as it limits action. Moreover, the approach is being applied to no great base position. Wesco is sort of scrambling through the years without owning a single business, even a small one, with enough commercial advantage in place to pretty well assure high future returns on its capital. In contrast, Berkshire Hathaway, Wesco's parent corporation, owns a fair number of such high-return businesses.

On January 22, 1987, Wesco increased its regular quarterly dividend from 16½ cents per share to 17½ cents per share, payable March 12, 1987, to shareholders of record as of the close of business on February 20, 1987.

This annual report contains Form 10-K, a report filed with the Securities and Exchange Commission, and includes detailed information about Wesco and its subsidiaries as well as audited financial statements bearing extensive footnotes. As usual, your careful attention is sought with respect to these items.

Charles T Munger

Charles T. Munger
Chairman of the Board

February 13, 1987

BERKSHIRE HATHAWAY INC.

SHAREHOLDER-DESIGNATED CONTRIBUTIONS

The Company has conducted this program of corporate giving for six years. On October 14, 1981, the Chairman sent to the shareholders a letter giving the reasons for the program. Portions of that letter follow:

"On September 30, 1981 Berkshire received a tax ruling from the U.S. Treasury Department that, in most years, should produce a significant benefit for charities of your choice.

"Each Berkshire shareholder — on a basis proportional to the number of shares of Berkshire that he owns — will be able to designate recipients of charitable contributions by our company. You'll name the charity; Berkshire will write the check. The ruling states that there will be no personal tax consequences to our shareholders from making such designations.

"Thus, our approximately 1500 owners now can exercise a perquisite that, although routinely exercised by the owners in closely-held businesses, is almost exclusively exercised by the managers in more widely-held businesses.

"In a widely-held corporation the executives ordinarily arrange all charitable donations, with no input at all from shareholders, in two main categories:

(1) Donations considered to benefit the corporation directly in an amount roughly commensurate with the cost of the donation; and
(2) Donations considered to benefit the corporation indirectly through hard-to-measure, long-delayed feedback effects of various kinds.

"I and other Berkshire executives have arranged in the past, as we will arrange in the future, all charitable donations in the first category. However, the aggregate level of giving in such category has been quite low, and very likely will remain quite low, because not many gifts can be shown to produce roughly commensurate direct benefits to Berkshire.

"In the second category, Berkshire's charitable gifts have been virtually nil, because I am not comfortable with ordinary corporate practice and had no better practice to substitute. What bothers me about ordinary corporate practice is the way gifts tend to be made based more on who does the asking and how corporate peers are responding than on an objective evaluation of the donee's activities. Conventionality often overpowers rationality.

"A common result is the use of the stockholder's money to implement the charitable inclinations of the corporate manager, who usually is heavily influenced by specific social pressures on him. Frequently there is an added incongruity; many corporate managers deplore governmental allocation of the taxpayer's dollar but embrace enthusiastically their own allocation of the shareholder's dollar.

"For Berkshire, a different model seems appropriate. Just as I wouldn't want you to implement your personal judgments by writing checks on my bank account for charities of your choice, I feel it inappropriate to write checks on your corporate "bank account" for charities of my choice. Your charitable preferences are as good as mine and, for both you and me, funds available to foster charitable interests in a tax-deductible manner reside largely at the corporate level rather than in our own hands.

"Under such circumstances, I believe Berkshire should imitate more closely-held companies, not larger public companies. If you and I each owned 50% of a corporation, our charitable decision making would be simple. Charities very directly related to the operations of the business would have first claim on our available charitable funds. Any balance available after the "operations-related' contributions would be divided among various charitable interests of the two of us, on a basis roughly proportional to our ownership interest. If the manager of our company had some suggestions, we would listen carefully — but the final decision would be ours. Despite our corporate form, in this aspect of the business we probably would behave as if we were a partnership.

"Wherever feasible, I believe in maintaining such a partnership frame of mind, even though we operate through a large, fairly widely-held corporation. Our Treasury ruling will allow such partnership-like behavior in this area . . .

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"I am pleased that Berkshire donations can become owner-directed. It is ironic, but understandable, that a large and growing number of major corporations have charitable policies pursuant to which they will match gifts made by their employees (and — brace yourself for this one — many even match gifts made by directors) but none, to my knowledge, has a plan matching charitable gifts by owners. I say "understandable" because much of the stock of many large corporations is owned on a "revolving door" basis by institutions that have short-term investment horizons, and that lack a long-term owner's perspective . . .

"Our own shareholders are a different breed. As I mentioned in the 1979 annual report, at the end of each year more than 98% of our shares are owned by people who were shareholders at the beginning of the year. This long-term commitment to the business reflects an owner mentality which, as your manager, I intend to acknowledge in all feasible ways. The designated contributions policy is an example of that intent."

* * *

The history of contributions made pursuant to this program since its inception follows:

Year	*Specified Amount per Share*	*Percent of Eligible* Shares Participating*	*Amount Contributed*	*No. of Charities*
1981	$2	95.6%	1,783,655	675
1982	$1	95.8%	890,948	704
1983	$3	96.4%	3,066,501	1,353
1984	$3	97.2%	3,179,049	1,519
1985	$4	96.8%	4,006,260	1,724
1986	$4	97.1%	3,996,820	1,934

**Shares registered in street name are not eligible to participate.*

In addition to the shareholder-designated contributions summarized above, Berkshire and its subsidiaries made certain contributions pursuant to local level decisions of operating managers of the businesses.

* * *

There may be an occasional year when contributions by Berkshire will produce substandard tax deductions — or none at all. In those years we will not effect our shareholder designated charitable program. In all other years we expect to inform you about October 10th of the amount per share that you may designate. A reply form will accompany the notice, and you will be given about six weeks — or until about November 30 — to respond with your designation. *Shareholders should note that replies received after that deadline are not processed.*

Shareholders should also note the fact that shares held in street name are not eligible to participate in the program. *To qualify, your shares must be registered in your own name or the name of an owning trust, corporation, partnership or estate, if applicable, on our stockholder list of September 30th, or the Friday preceding if such date falls on a Saturday or Sunday.*

BERKSHIRE HATHAWAY INC.
Selected Financial Data for the Past Five Years
(dollars in thousands — except per share amounts)

	1982	1983	1984	1985	1986
Revenues of consolidated companies:					
Sales and service revenues	$ 306,564	$ 381,674	$ 500,219	$ 508,764	$1,225,290
Insurance premiums earned	152,945	152,480	140,242	317,059	823,884
Interest and dividend income	58,003	64,903	84,161	107,662	118,429
Earnings:					
Before realized investment gain	$ 31,497	$ 48,644	$ 70,201	$ 92,948	$ 131,464
Realized investment gain	14,877	63,522	78,694	342,867	150,897
Net earnings	$ 46,374	$ 112,166	$ 148,895	$ 435,815	$ 282,361
Common shares outstanding — average in thousands	987	1,067	1,147	1,147	1,147
Earnings per share:					
Before realized investment gain	$ 31.93	$ 45.60	$ 61.21	$ 81.04	$ 114.62
Net earnings	47.01	105.15	129.82	379.99	246.19
Year-end data					
Total assets	$1,514,431	$1,837,543	$2,035,203	$3,180,718	$4,441,655
Term debt and other borrowings ...	169,947	128,984	127,104	117,879	94,923
Minority shareholders' interest	101,177	17,990	22,299	34,360	43,289
Stockholders' equity — total	727,483	1,119,193	1,271,761	1,885,330	2,377,797
Shares of common stock outstanding — in thousands	987	1,147	1,147	1,147	1,147
Stockholders' equity — per outstanding share	$ 737.06	$ 975.76	$ 1,108.77	$ 1,643.71	$ 2,073.06

DIRECTORS AND OFFICERS OF THE COMPANY

WARREN E. BUFFETT, *Director and Chairman of the Board,*
Chief Executive Officer

CHARLES T. MUNGER, *Director and Vice Chairman of the Board*

KENNETH V. CHACE, *Director*
Retired, Former Chief Operating Officer of the Textile Operations

MALCOLM G. CHACE, JR., *Director*
Retired, Former Chairman of the Board of Directors

J. VERNE MCKENZIE, *Director*
Vice President, Secretary and Treasurer

ROBERT H. BIRD, *Vice President*

MICHAEL A. GOLDBERG, *Vice President*

DANIEL J. JAKSICH, *Controller*

J. WILLIAM SCOTT, *Vice President*

COMMON STOCK DATA

Shareholders

The Company had approximately 4,100 record holders of its common stock at March 10, 1987.

Market Prices

The common stock of Berkshire Hathaway Inc. is traded in the over the counter market and price quotations are reported through the National Association of Securities Dealers Automated Quotation System ("NASDAQ") under the symbol BKHT. On April 16, 1985, Berkshire was entered in NASDAQ's National Market System ("NMS"). Thus, the following information includes bid quotations for 1985 (through April 16) which represent prices between dealers and do not include retail markup, markdown or commission. They do not represent actual transactions. Quotations subsequent to Berkshire's entry into the NMS are high and low sale prices.

1986	High	Low
First Quarter	$3,250	$2,220
Second Quarter	3,160	2,640
Third Quarter	3,100	2,525
Fourth Quarter	2,925	2,620

1985	High	Low
First Quarter	$1,930	$1,275
Second Quarter	2,160	1,725
Third Quarter	2,235	2,005
Fourth Quarter	2,730	2,075

Dividends

Berkshire has not declared a cash dividend since 1967.

Stock Transfer Agent

The First National Bank of Boston, P.O. Box 644, Boston, MA 02102 serves as Transfer Agent for the Company's common stock. Certificates to be transferred should be mailed directly to the Transfer Agent, preferably by registered mail. Certificates to be transferred should not be mailed to the Company.

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APRIL 1987

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