BERKSHIRE HATHAWAY INC.

1988
ANNUAL REPORT TO THE STOCKHOLDERS

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

	1964	1970	1976	1982	1988
Revenues:					
Sales and service revenues	$ 49,983	$ 24,569	$ 47,174	$ 306,564	$1,407,642
Insurance premiums earned	—	39,173	80,780	152,945	584,235
Investment income-insurance group	—	3,077	10,543	41,791	231,907
Total revenues	49,983	66,880	139,069	544,832	2,333,222
Earnings (loss) data:					
Before realized investment gain	$ (2,824)	$ 4,507	$ 16,073	$ 31,497	$ 313,441
Realized investment gain	—	58	6,762	14,877	85,829
Net earnings	$ (2,824)	$ 4,565	$ 22,835	$ 46,374	$ 399,270
Year-end data:					
Total assets	$ 27,887	$ 113,212	$ 283,041	$1,723,993	$6,816,848
Term debt and other borrowings	2,500	5,891	24,987	169,947	480,009
Minority shareholders' interest	—	—	—	111,596	66,396
Shareholders' equity — total	22,139	48,483	115,293	727,483	3,410,108
Shares of common stock outstanding — in thousands	1,138	980	973	987	1,146
Shareholders' equity per outstanding share	$ 19.46	$ 49.49	$ 118.49	$ 737.06	$ 2,974.52

The 1964 fiscal year was the 52 week period ended October 3, 1964. The years 1970, 1976 and 1982 were 52 week fiscal years that ended on Saturday nearest December 31. Data reflected above are presented in conformity with 1988 consolidation and accounting practices; accordingly certain prior year data has been restated or reclassified.

BERKSHIRE HATHAWAY INC. and its subsidiaries engage in a number of diverse business activities. The most important of these is the property and casualty insurance and reinsurance business conducted nationwide through a number of subsidiaries. Substantial other business activities are conducted in unrelated fields including manufacturing, publishing, and retailing.

Investment portfolios of insurance subsidiaries include meaningful ownership percentages of security issues of other publicly traded companies, including: GEICO Corporation, Capital Cities/ABC, Inc., Washington Post Company and Salomon Inc.

Operating decisions for the various Berkshire business units are made by unit managers. Investment decisions and all other capital allocation decisions are made for Berkshire and its subsidiaries 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.

Certain **OWNER-RELATED BUSINESS PRINCIPLES** were included in the Chairman's letter to Shareholders of Berkshire Hathaway Inc. in the 1983 Annual Report. Because the material remains topical, it is reproduced on this and the following page.

With so many new shareholders, it's appropriate to summarize the major business principles we follow that pertain to the manager-owner relationship:

- 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 major shareholders of Berkshire Hathaway. In the case of at least four, 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.")

BERKSHIRE HATHAWAY INC.

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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 1988 was $569 million, or 20.0%. Over the last 24 years (that is, since present management took over), our per-share book value has grown from $19.46 to $2,974.52, or at a rate of 23.0% compounded annually.

We've emphasized in past reports that what counts, however, is intrinsic business value — the figure, necessarily an estimate, indicating what all of our constituent businesses are worth. By our calculations, Berkshire's intrinsic business value significantly exceeds its book value. Over the 24 years, business value has grown somewhat faster than book value; in 1988, however, book value grew the faster, by a bit.

Berkshire's past rates of gain in both book value and business value were achieved under circumstances far different from those that now exist. Anyone ignoring these differences makes the same mistake that a baseball manager would were he to judge the future prospects of a 42-year-old center fielder on the basis of his lifetime batting average.

Important negatives affecting our prospects today are: (1) a less attractive stock market than generally existed over the past 24 years; (2) higher corporate tax rates on most forms of investment income; (3) a far more richly-priced market for the acquisition of businesses; and (4) industry conditions for Capital Cities/ABC, Inc., GEICO Corporation, and The Washington Post Company — Berkshire's three permanent investments, constituting about one-half of our net worth — that range from slightly to materially less favorable than those existing five to ten years ago. All of these companies have superb management and strong properties. But, at current prices, their upside potential looks considerably less exciting to us today than it did some years ago.

The major problem we face, however, is a growing capital base. You've heard that from us before, but this problem, like age, grows in significance each year. (And also, just as with age, it's better to have this problem continue to grow rather than to have it "solved.")

Four years ago I told you that we needed profits of $3.9 billion to achieve a 15% annual return over the decade then ahead. Today, for the next decade, a 15% return demands profits of $10.3 billion. That seems like a very big number to me and to Charlie Munger, Berkshire's Vice Chairman and my partner. (Should that number indeed prove too big, Charlie will find himself, in future reports, retrospectively identified as the senior partner.)

As a partial offset to the drag that our growing capital base exerts upon returns, we have a very important advantage now that we lacked 24 years ago. Then, all our capital was tied up in a textile business with inescapably poor economic characteristics. Today part of our capital is invested in some really exceptional businesses.

Last year we dubbed these operations the Sainted Seven: Buffalo News, Fechheimer, Kirby, Nebraska Furniture Mart, Scott Fetzer Manufacturing Group, See's, and World Book. In 1988 the Saints came marching in. You can see just how extraordinary their returns on capital were by examining the historical-cost financial statements on page 45, which combine the figures of the Sainted Seven with those of several smaller units. With no benefit from financial leverage, this group earned about 67% on average equity capital.

In most cases the remarkable performance of these units arises partially from an exceptional business franchise; in all cases an exceptional management is a vital factor. The contribution Charlie and I make is to leave these managers alone.

In my judgment, these businesses, in aggregate, will continue to produce superb returns. We'll need these: Without this help Berkshire would not have a chance of achieving our 15% goal. You can be sure that our operating managers will deliver; the question mark in our future is whether Charlie and I can effectively employ the funds that they generate.

In that respect, we took a step in the right direction early in 1989 when we purchased an 80% interest in Borsheim's, a jewelry business in Omaha. This purchase, described later in this letter, delivers exactly what we look for: an outstanding business run by people we like, admire, and trust. It's a great way to start the year.

Accounting Changes

We have made a significant accounting change that was mandated for 1988, and likely will have another to make in 1990. When we move figures around from year to year, without any change in economic reality, one of our always-thrilling discussions of accounting is necessary.

First, I'll offer my customary disclaimer: Despite the shortcomings of generally accepted accounting principles (GAAP), I would hate to have the job of devising a better set of rules. The limitations of the existing set, however, need not be inhibiting: CEOs are free to treat GAAP statements as a beginning rather than an end to their obligation to inform owners and creditors — and indeed they should. After all, any manager of a subsidiary company would find himself in hot water if he reported barebones GAAP numbers that omitted key information needed by his boss, the parent corporation's CEO. Why, then, should the CEO himself withhold information vitally useful to *his* bosses — the shareholder-owners of the corporation?

What needs to be reported is data — whether GAAP, non-GAAP, or extra-GAAP — that helps financially-literate readers answer three key questions: (1) Approximately how much is this company worth? (2) What is the likelihood that it can meet its future obligations? and (3) How good a job are its managers doing, given the hand they have been dealt?

In most cases, answers to one or more of these questions are somewhere between difficult and impossible to glean from the minimum GAAP presentation. The business world is simply too complex for a single set of rules to effectively describe economic reality for all enterprises, particularly those operating in a wide variety of businesses, such as Berkshire.

Further complicating the problem is the fact that many managements view GAAP not as a standard to be met, but as an obstacle to overcome. Too often their accountants willingly assist them. ("How much," says the client, "is two plus two?" Replies the cooperative accountant, "What number did you have in mind?") Even honest and well-intentioned managements sometimes stretch GAAP a bit in order to present figures they think will more appropriately describe their performance. Both the smoothing of earnings and the "big bath" quarter are "white lie" techniques employed by otherwise upright managements.

Then there are managers who actively use GAAP to deceive and defraud. They know that many investors and creditors accept GAAP results as gospel. So these charlatans interpret the rules "imaginatively" and record business transactions in ways that technically comply with GAAP but actually display an economic illusion to the world.

As long as investors — including supposedly sophisticated institutions — place fancy valuations on reported "earnings" that march steadily upward, you can be sure that some managers and promoters will exploit GAAP to produce such numbers, no matter what the truth may be. Over the years, Charlie and I have observed many accounting-based frauds of staggering size. Few of the perpetrators have been punished; many have not even been censured. It has been far safer to steal large sums with a pen than small sums with a gun.

Under one major change mandated by GAAP for 1988, we have been required to fully consolidate all our subsidiaries in our balance sheet and earnings statement. In the past, Mutual Savings and Loan, and Scott Fetzer Financial (a credit company that primarily finances installment sales of World Book and Kirby products) were consolidated on a "one-line" basis. That meant we (1) showed our equity in their combined net worths as a single-entry asset on Berkshire's consolidated balance sheet and (2) included our equity in their combined annual earnings as a single-line income entry in our consolidated statement of earnings. Now the rules require that we consolidate each asset and liability of these companies in our balance sheet and each item of their income and expense in our earnings statement.

This change underscores the need for companies also to report segmented data: The greater the number of economically diverse business operations lumped together in conventional financial statements, the less useful those presentations are and the less able investors are to answer the three questions posed earlier. Indeed, the only reason we ever prepare consolidated figures at Berkshire is to meet outside requirements. On the other hand, Charlie and I constantly study our segment data.

Now that we are required to bundle more numbers in our GAAP statements, we have decided to publish additional supplementary information that we think will help you measure both business value and managerial performance. (Berkshire's ability to discharge its obligations to creditors — the third question we listed — should be obvious, whatever statements you examine.) In these supplementary presentations, we will not necessarily follow GAAP procedures, or even corporate structure. Rather, we will attempt to lump major business activities in ways that aid analysis but do not swamp you with detail. Our goal is to give you important information in a form that we would wish to get it if our roles were reversed.

On pages 41-47 we show separate combined balance sheets and earnings statements for: (1) our subsidiaries engaged in finance-type operations, which are Mutual Savings and Scott Fetzer Financial; (2) our insurance operations, with their major investment positions itemized; (3) our manufacturing, publishing and retailing businesses, leaving aside certain non-operating assets and purchase-price accounting adjustments; and (4) an all-other category that includes the non-operating assets (primarily marketable securities) held by the companies in (3) as well as various assets and debts of the Wesco and Berkshire parent companies.

If you combine the earnings and the net worths of these four segments, you will derive totals matching those shown on our GAAP statements. However, we want to emphasize that our new presentation does not fall within the purview of our auditors, who in no way bless it. (In fact, they may be horrified; I don't want to ask.)

I referred earlier to a major change in GAAP that is expected in 1990. This change relates to the calculation of deferred taxes, and is both complicated and controversial — so much so that its imposition, originally scheduled for 1989, was postponed for a year.

When implemented, the new rule will affect us in various ways. Most important, we will be required to change the way we calculate our liability for deferred taxes on the unrealized appreciation of stocks held by our insurance companies.

Right now, our liability is layered. For the unrealized appreciation that dates back to 1986 and earlier years, $1.2 billion, we have booked a 28% tax liability. For the unrealized appreciation built up since, $600 million, the tax liability has been booked at 34%. The difference reflects the increase in tax rates that went into effect in 1987.

It now appears, however, that the new accounting rule will require us to establish the entire liability at 34% in 1990, taking the charge against our earnings. Assuming no change in tax rates by 1990, this step will reduce our earnings in that year (and thereby our reported net worth) by $71 million. The proposed rule will also affect other items on our balance sheet, but these changes will have only a minor impact on earnings and net worth.

We have no strong views about the desirability of this change in calculation of deferred taxes. We should point out, however, that neither a 28% nor a 34% tax liability precisely depicts economic reality at Berkshire since we have no plans to sell the stocks in which we have the great bulk of our gains.

To those of you who are uninterested in accounting, I apologize for this dissertation. I realize that many of you do not pore over our figures, but instead hold Berkshire primarily because you know that: (1) Charlie and I have the bulk of our money in Berkshire; (2) we intend to run things so that your gains or losses are in direct proportion to ours; and (3) the record has so far been satisfactory. There is nothing necessarily wrong with this kind of "faith" approach to investing. Other shareholders, however, prefer an "analysis" approach and we want to supply the information they need. In our own investing, we search for situations in which both approaches give us the same answer.

Sources of Reported Earnings

In addition to supplying you with our new four-sector accounting material, we will continue to list the major sources of Berkshire's reported earnings just as we have in the past.

In the following table, amortization of Goodwill and other major purchase-price accounting adjustments are not charged against the specific businesses to which they apply but are instead aggregated and shown separately. This procedure lets you view the earnings of our businesses as they would have been reported had we not purchased them. I've explained in past reports why this form of presentation seems to us to be more useful to investors and managers than the standard GAAP presentation, which makes purchase-price adjustments on a business-by-business basis. The total net earnings we show in the table are, of course, identical to the GAAP total in our audited financial statements.

Further information about these businesses is given in the Business Segment section on pages 32-34, and in the Management's Discussion section on pages 36-40. In these sections you also will find our segment earnings reported on a GAAP basis. For information on Wesco's businesses, I urge you to read Charlie Munger's letter, which starts on page 52. It contains the best description I have seen of the events that produced the present savings-and-loan crisis. Also, take special note of Dave Hillstrom's performance at Precision Steel Warehouse, a Wesco subsidiary. Precision operates in an extremely competitive industry, yet Dave consistently achieves good returns on invested capital. Though data is lacking to prove the point, I think it is likely that his performance, both in 1988 and years past, would rank him number one among his peers.

	(000s omitted)			
	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1988	*1987*	*1988*	*1987*
Operating Earnings:				
Insurance Group:				
Underwriting	$(11,081)	$(55,429)	$ (1,045)	$(20,696)
Net Investment Income	231,250	152,483	197,779	136,658
Buffalo News	42,429	39,410	25,462	21,304
Fechheimer	14,152	13,332	7,720	6,580
Kirby	26,891	22,408	17,842	12,891
Nebraska Furniture Mart	18,439	16,837	9,099	7,554
Scott Fetzer Manufacturing Group	28,542	30,591	17,640	17,555
See's Candies	32,473	31,693	19,671	17,363
Wesco — other than Insurance	16,133	6,209	10,650	4,978
World Book	27,890	25,745	18,021	15,136
Amortization of Goodwill	(2,806)	(2,862)	(2,806)	(2,862)
Other Purchase-Price Accounting Charges	(6,342)	(5,546)	(7,340)	(6,544)
Interest on Debt*	(35,613)	(11,474)	(23,212)	(5,905)
Shareholder-Designated Contributions	(4,966)	(4,938)	(3,217)	(2,953)
Other	41,059	23,217	27,177	13,697
Operating Earnings	418,450	281,676	313,441	214,746
Sales of Securities	131,671	28,838	85,829	19,806
Total Earnings — All Entities	$550,121	$310,514	$399,270	$234,552

**Excludes interest expense of Scott Fetzer Financial Group.*

The earnings achieved by our operating businesses are superb, whether measured on an absolute basis or against those of their competitors. For that we thank our operating managers: You and I are fortunate to be associated with them.

At Berkshire, associations like these last a long time. We do not remove superstars from our line-up merely because they have attained a specified age — whether the traditional 65, or the 95 reached by Mrs. B on the eve of Hanukkah in 1988. Superb managers are too scarce a resource to be discarded simply because a cake gets crowded with candles. Moreover, our experience with newly-minted MBAs has not been that great. Their academic records always look terrific and the candidates always know just what to say; but too often they are short on personal commitment to the company and general business savvy. It's difficult to teach a new dog old tricks.

Here's an update on our major non-insurance operations:

• At Nebraska Furniture Mart, Mrs. B (Rose Blumkin) and her cart roll on and on. She's been the boss for 51 years, having started the business at 44 with $500. (Think what she would have done with $1,000!) With Mrs. B, old age will always be ten years away.

The Mart, long the largest home furnishings store in the country, continues to grow. In the fall, the store opened a detached 20,000 square foot Clearance Center, which expands our ability to offer bargains in all price ranges.

Recently Dillard's, one of the most successful department store operations in the country, entered the Omaha market. In many of its stores, Dillard's runs a full furniture department, undoubtedly doing well in this line. Shortly before opening in Omaha, however, William Dillard, chairman of the company, announced that his new store would not sell furniture. Said he, referring to NFM: "We don't want to compete with them. We think they are about the best there is."

At the Buffalo News we extol the value of advertising, and our policies at NFM prove that we practice what we preach. Over the past three years NFM has been the largest ROP advertiser in the Omaha World-Herald. (ROP advertising is the kind printed in the paper, as contrasted to the preprinted-insert kind.) In no other major market, to my knowledge, is a home furnishings operation the leading customer of the newspaper. At times, we also run large ads in papers as far away as Des Moines, Sioux City and Kansas City — always with good results. It truly does pay to advertise, as long as you have something worthwhile to offer.

Mrs. B's son, Louie, and his boys, Ron and Irv, complete the winning Blumkin team. It's a joy to work with this family. All its members have character that matches their extraordinary abilities.

• Last year I stated unequivocally that pre-tax margins at The Buffalo News would fall in 1988. That forecast would have proved correct at almost any other newspaper our size or larger. But Stan Lipsey — bless him — has managed to make me look foolish.

Though we increased our prices a bit less than the industry average last year, and though our newsprint costs and wage rates rose in line with industry norms, Stan actually improved margins a tad. No one in the newspaper business has a better managerial record. He has achieved it, furthermore, while running a paper that gives readers an extraordinary amount of news. We believe that our "news-hole" percentage — the portion of the paper devoted to news — is bigger than that of any other dominant paper of our size or larger. The percentage was 49.5% in 1988 versus 49.8% in 1987. We are committed to keeping it around 50%, whatever the level or trend of profit margins.

Charlie and I have loved the newspaper business since we were youngsters, and we have had great fun with the News in the 12 years since we purchased it. We were fortunate to find Murray Light, a top-flight editor, on the scene when we arrived and he has made us proud of the paper ever since.

• See's Candies sold a record 25.1 million pounds in 1988. Prospects did not look good at the end of October, but excellent Christmas volume, considerably better than the record set in 1987, turned the tide.

As we've told you before, See's business continues to become more Christmas-concentrated. In 1988, the Company earned a record 90% of its full-year profits in December: $29 million out of $32.5

million before tax. (It's enough to make you believe in Santa Claus.) December's deluge of business produces a modest seasonal bulge in Berkshire's corporate earnings. Another small bulge occurs in the first quarter, when most World Book annuals are sold.

Charlie and I put Chuck Huggins in charge of See's about five minutes after we bought the company. Upon reviewing his record, you may wonder what took us so long.

• At Fechheimer, the Heldmans — Bob, George, Gary, Roger and Fred — are the Cincinnati counterparts of the Blumkins. Neither furniture retailing nor uniform manufacturing has inherently attractive economics. In these businesses, only exceptional managements can deliver high returns on invested capital. And that's exactly what the five Heldmans do. (As Mets announcer Ralph Kiner once said when comparing pitcher Steve Trout to his father, Dizzy Trout, the famous Detroit Tigers pitcher: "There's a lot of heredity in that family.")

Fechheimer made a fairly good-sized acquisition in 1988. Charlie and I have such confidence in the business savvy of the Heldman family that we okayed the deal without even looking at it. There are very few managements anywhere — including those running the top tier companies of the Fortune 500 — in which we would exhibit similar confidence.

Because of both this acquisition and some internal growth, sales at Fechheimer should be up significantly in 1989.

• All of the operations managed by Ralph Schey — World Book, Kirby, and The Scott Fetzer Manufacturing Group — performed splendidly in 1988. Returns on the capital entrusted to Ralph continue to be exceptional.

Within the Scott Fetzer Manufacturing Group, particularly fine progress was recorded at its largest unit, Campbell Hausfeld. This company, the country's leading producer of small and medium-sized air compressors, has more than doubled earnings since 1986.

Unit sales at both Kirby and World Book were up significantly in 1988, with export business particularly strong. World Book became available in the Soviet Union in September, when that country's largest American book store opened in Moscow. Ours is the only general encyclopedia offered at the store.

Ralph's personal productivity is amazing: In addition to running 19 businesses in superb fashion, he is active at The Cleveland Clinic, Ohio University, Case Western Reserve, and a venture capital operation that has spawned sixteen Ohio-based companies and resurrected many others. Both Ohio and Berkshire are fortunate to have Ralph on their side.

Borsheim's

It was in 1983 that Berkshire purchased an 80% interest in The Nebraska Furniture Mart. Your Chairman blundered then by neglecting to ask Mrs. B a question any schoolboy would have thought of: "Are there any more at home like you?" Last month I corrected the error: We are now 80% partners with another branch of the family.

After Mrs. B came over from Russia in 1917, her parents and five siblings followed. (Her two other siblings had preceded her.) Among the sisters was Rebecca Friedman who, with her husband, Louis, escaped in 1922 to the west through Latvia in a journey as perilous as Mrs. B's earlier odyssey to the east through Manchuria. When the family members reunited in Omaha they had no tangible assets. However, they came equipped with an extraordinary combination of brains, integrity, and enthusiasm for work — and that's all they needed. They have since proved themselves invincible.

In 1948 Mr. Friedman purchased Borsheim's, a small Omaha jewelry store. He was joined in the business by his son, Ike, in 1950 and, as the years went by, Ike's son, Alan, and his sons-in-law, Marvin Cohn and Donald Yale, came in also.

You won't be surprised to learn that this family brings to the jewelry business precisely the same approach that the Blumkins bring to the furniture business. The cornerstone for both enterprises is Mrs. B's creed: "Sell cheap and tell the truth." Other fundamentals at both businesses are: (1) single-store operations featuring huge inventories that provide customers with an enormous selection across all price ranges, (2) daily attention to detail by top management, (3) rapid turnover, (4) shrewd buying, and (5) incredibly low expenses. The combination of the last three factors lets both stores offer everyday prices that no one in the country comes close to matching.

Most people, no matter how sophisticated they are in other matters, feel like babes in the woods when purchasing jewelry. They can judge neither quality nor price. For them only one rule makes sense: If you don't know jewelry, know the jeweler.

I can assure you that those who put their trust in Ike Friedman and his family will never be disappointed. The way in which we purchased our interest in their business is the ultimate testimonial. Borsheim's had no audited financial statements; nevertheless, we didn't take inventory, verify receivables or audit the operation in any way. Ike simply told us what was so — and on that basis we drew up a one-page contract and wrote a large check.

Business at Borsheim's has mushroomed in recent years as the reputation of the Friedman family has spread. Customers now come to the store from all over the country. Among them have been some friends of mine from both coasts who thanked me later for getting them there.

Borsheim's new links to Berkshire will change nothing in the way this business is run. All members of the Friedman family will continue to operate just as they have before; Charlie and I will stay on the sidelines where we belong. And when we say "all members," the words have real meaning. Mr. and Mrs. Friedman, at 88 and 87, respectively, are in the store daily. The wives of Ike, Alan, Marvin and Donald all pitch in at busy times, and a fourth generation is beginning to learn the ropes.

It is great fun to be in business with people you have long admired. The Friedmans, like the Blumkins, have achieved success because they have deserved success. Both families focus on what's right for the customer and that, inevitably, works out well for them, also. We couldn't have better partners.

Insurance Operations

Shown below is an updated version of our usual table presenting key figures for the insurance industry:

	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	9.6
1982	3.7	109.6	8.4	6.4
1983	5.0	112.0	6.8	3.8
1984	8.5	118.0	16.9	3.7
1985	22.1	116.3	16.1	3.2
1986	22.2	108.0	13.5	2.7
1987	9.4	104.6	7.8	3.3
1988 (Est.)	3.9	105.4	4.2	3.6

Source: A.M. Best Co.

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 107-111 range typically produces an overall breakeven result, exclusive of earnings on the funds provided by shareholders.

For the reasons laid out in previous reports, we expect the industry's incurred losses to grow by about 10% annually, even in years when general inflation runs considerably lower. If premium growth meanwhile materially lags that 10% rate, underwriting losses will mount, though the industry's tendency to underreserve when business turns bad may obscure their size for a time. As the table shows, the industry's underwriting loss grew in 1988. This trend is almost certain to continue — and probably will accelerate — for at least two more years.

The property-casualty insurance industry is not only subnormally profitable, it is subnormally popular. (As Sam Goldwyn philosophized: "In life, one must learn to take the bitter with the sour.") One of the ironies of business is that many relatively-unprofitable industries that are plagued by inadequate prices habitually find themselves beat upon by irate customers even while other, hugely-profitable industries are spared complaints, no matter how high their prices.

Take the breakfast cereal industry, whose return on invested capital is more than double that of the auto insurance industry (which is why companies like Kellogg and General Mills sell at five times book value and most large insurers sell close to book). The cereal companies regularly impose price increases, few of them related to a significant jump in their costs. Yet not a peep is heard from consumers. But when auto insurers raise prices by amounts that do not even match cost increases, customers are outraged. If you want to be loved, it's clearly better to sell high-priced corn flakes than low-priced auto insurance.

The antagonism that the public feels toward the industry can have serious consequences: Proposition 103, a California initiative passed last fall, threatens to push auto insurance prices down sharply, even though costs have been soaring. The price cut has been suspended while the courts review the initiative, but the resentment that brought on the vote has not been suspended: Even if the initiative is overturned, insurers are likely to find it tough to operate profitably in California. (Thank heavens the citizenry isn't mad at bonbons: If Proposition 103 applied to candy as well as insurance, See's would be forced to sell its product for $5.76 per pound rather than the $7.60 we charge — and would be losing money by the bucketful.)

The immediate direct effects on Berkshire from the initiative are minor, since we saw few opportunities for profit in the rate structure that existed in California prior to the vote. However, the forcing down of prices would seriously affect GEICO, our 44%-owned investee, which gets about 10% of its premium volume from California. Even more threatening to GEICO is the possibility that similar pricing actions will be taken in other states, through either initiatives or legislation.

If voters insist that auto insurance be priced below cost, it eventually must be sold by government. Stockholders can subsidize policyholders for a short period, but only taxpayers can subsidize them over the long term. At most property-casualty companies, socialized auto insurance would be no disaster for shareholders. Because of the commodity characteristics of the industry, most insurers earn mediocre returns and therefore have little or no economic goodwill to lose if they are forced by government to leave the auto insurance business. But GEICO, because it is a low-cost producer able to earn high returns on equity, has a huge amount of economic goodwill at risk. In turn, so do we.

At Berkshire, in 1988, our premium volume continued to fall, and in 1989 we will experience a large decrease for a special reason: The contract through which we receive 7% of the business of Fireman's Fund expires on August 31. At that time, we will return to Fireman's Fund the unearned premiums we hold that relate to the contract. This transfer of funds will show up in our "premiums written" account as a negative $85 million or so and will make our third-quarter figures look rather peculiar. However, the termination of this contract will not have a significant effect on profits.

Berkshire's underwriting results continued to be excellent in 1988. Our combined ratio (on a statutory basis and excluding structured settlements and financial reinsurance) was 104. Reserve development was favorable for the second year in a row, after a string of years in which it was very unsatisfactory. Details on both underwriting and reserve development appear on pages 36-38.

Our insurance volume over the next few years is likely to run very low, since business with a reasonable potential for profit will almost certainly be scarce. So be it. At Berkshire, we simply will not write policies at rates that carry the expectation of economic loss. We encounter enough troubles when we expect a gain.

Despite — or perhaps because of — low volume, our profit picture during the next few years is apt to be considerably brighter than the industry's. We are sure to have an exceptional amount of float compared to premium volume, and that augurs well for profits. In 1989 and 1990 we expect our float/premiums ratio to be at least three times that of the typical property/casualty company. Mike Goldberg, with special help from Ajit Jain, Dinos Iordanou, and the National Indemnity managerial team, has positioned us well in that respect.

At some point — we don't know when — we will be deluged with insurance business. The cause will probably be some major physical or financial catastrophe. But we could also experience an explosion in business, as we did in 1985, because large and increasing underwriting losses at other companies coincide with their recognition that they are far underreserved. In the meantime, we will retain our talented professionals, protect our capital, and try not to make major mistakes.

Marketable Securities

In selecting marketable securities for our insurance companies, we can choose among five major categories: (1) long-term common stock investments, (2) medium-term fixed-income securities, (3) long-term fixed-income securities, (4) short-term cash equivalents, and (5) short-term arbitrage commitments.

We have no particular bias when it comes to choosing from these categories. We just continuously search among them for the highest after-tax returns as measured by "mathematical expectation," limiting ourselves always to investment alternatives we think we understand. Our criteria have nothing to do with maximizing immediately reportable earnings; our goal, rather, is to maximize eventual net worth.

● Below we list our common stock holdings having a value over $100 million, not including arbitrage commitments, which will be discussed later. A small portion of these investments belongs to subsidiaries of which Berkshire owns less than 100%.

Shares	*Company*	*Cost*	*Market*
		(000s omitted)	
3,000,000	Capital Cities/ABC, Inc.	$517,500	$1,086,750
14,172,500	The Coca-Cola Company	592,540	632,448
2,400,000	Federal Home Loan Mortgage Corporation Preferred*	71,729	121,200
6,850,000	GEICO Corporation	45,713	849,400
1,727,765	The Washington Post Company	9,731	364,126

**Although nominally a preferred stock, this security is financially equivalent to a common stock.*

Our permanent holdings — Capital Cities/ABC, Inc., GEICO Corporation, and The Washington Post Company — remain unchanged. Also unchanged is our unqualified admiration of their managements: Tom Murphy and Dan Burke at Cap Cities, Bill Snyder and Lou Simpson at GEICO, and Kay Graham and Dick Simmons at The Washington Post. Charlie and I appreciate enormously the talent and integrity these managers bring to their businesses.

Their performance, which we have observed at close range, contrasts vividly with that of many CEOs, which we have fortunately observed from a safe distance. Sometimes these CEOs clearly do not belong in their jobs; their positions, nevertheless, are usually secure. The supreme irony of business management is that it is far easier for an inadequate CEO to keep his job than it is for an inadequate subordinate.

If a secretary, say, is hired for a job that requires typing ability of at least 80 words a minute and turns out to be capable of only 50 words a minute, she will lose her job in no time. There is a logical standard for this job; performance is easily measured; and if you can't make the grade, you're out. Similarly, if new sales people fail to generate sufficient business quickly enough, they will be let go. Excuses will not be accepted as a substitute for orders.

However, a CEO who doesn't perform is frequently carried indefinitely. One reason is that performance standards for his job seldom exist. When they do, they are often fuzzy or they may be waived or explained away, even when the performance shortfalls are major and repeated. At too many companies, the boss shoots the arrow of managerial performance and then hastily paints the bullseye around the spot where it lands.

Another important, but seldom recognized, distinction between the boss and the foot soldier is that the CEO has no immediate superior whose performance is itself getting measured. The sales manager who retains a bunch of lemons in his sales force will soon be in hot water himself. It is in his immediate self-interest to promptly weed out his hiring mistakes. Otherwise, he himself may be weeded out. An office manager who has hired inept secretaries faces the same imperative.

But the CEO's boss is a Board of Directors that seldom measures itself and is infrequently held to account for substandard corporate performance. If the Board makes a mistake in hiring, and perpetuates that mistake, so what? Even if the company is taken over because of the mistake, the deal will probably bestow substantial benefits on the outgoing Board members. (The bigger they are, the softer they fall.)

Finally, relations between the Board and the CEO are expected to be congenial. At board meetings, criticism of the CEO's performance is often viewed as the social equivalent of belching. No such inhibitions restrain the office manager from critically evaluating the substandard typist.

These points should not be interpreted as a blanket condemnation of CEOs or Boards of Directors: Most are able and hard-working, and a number are truly outstanding. But the management failings that Charlie and I have seen make us thankful that we are linked with the managers of our three permanent holdings. They love their businesses, they think like owners, and they exude integrity and ability.

• In 1988 we made major purchases of Federal Home Loan Mortgage Pfd. ("Freddie Mac") and Coca Cola. We expect to hold these securities for a long time. In fact, when we own portions of outstanding businesses with outstanding managements, our favorite holding period is forever. We are just the opposite of those who hurry to sell and book profits when companies perform well but who tenaciously hang on to businesses that disappoint. Peter Lynch aptly likens such behavior to cutting the flowers and watering the weeds.

Our holdings of Freddie Mac are the maximum allowed by law, and are extensively described by Charlie in his letter. In our consolidated balance sheet these shares are carried at cost rather than market, since they are owned by Mutual Savings and Loan, a non-insurance subsidiary.

We continue to concentrate our investments in a very few companies that we try to understand well. There are only a handful of businesses about which we have strong long-term convictions. Therefore, when we find such a business, we want to participate in a meaningful way. We agree with Mae West: "Too much of a good thing can be wonderful."

• We reduced our holdings of medium-term tax-exempt bonds by about $100 million last year. All of the bonds sold were acquired after August 7, 1986. When such bonds are held by property-casualty insurance companies, 15% of the "tax-exempt" interest earned is subject to tax.

The $800 million position we still hold consists almost entirely of bonds "grandfathered" under the Tax Reform Act of 1986, which means they are entirely tax-exempt. Our sales produced a small profit and our remaining bonds, which have an average maturity of about six years, are worth modestly more than carrying value.

Last year we described our holdings of short-term and intermediate-term bonds of Texaco, which was then in bankruptcy. During 1988, we sold practically all of these bonds at a pre-tax profit of about $22 million. This sale explains close to $100 million of the reduction in fixed-income securities on our balance sheet.

We also told you last year about our holdings of another security whose predominant characteristics are those of an intermediate fixed-income issue: our $700 million position in Salomon Inc 9% convertible preferred. This preferred has a sinking fund that will retire it in equal annual installments from 1995 to 1999. Berkshire carries this holding at cost. For reasons discussed by Charlie on page 69, the estimated market value of our holding has improved from moderately under cost at the end of last year to moderately over cost at 1988 year end.

The close association we have had with John Gutfreund, CEO of Salomon, during the past year has reinforced our admiration for him. But we continue to have no great insights about the near, intermediate or long-term economics of the investment banking business: This is not an industry in which it is easy to forecast future levels of profitability. We continue to believe that our conversion privilege could well have important value over the life of our preferred. However, the overwhelming portion of the preferred's value resides in its fixed-income characteristics, not its equity characteristics.

• We have not lost our aversion to long-term bonds. We will become enthused about such securities only when we become enthused about prospects for long-term stability in the purchasing power of money. And that kind of stability isn't in the cards: Both society and elected officials simply have too many higher-ranking priorities that conflict with purchasing-power stability.

The only long-term bonds we hold are those of Washington Public Power Supply Systems (WPPSS). A few of our WPPSS bonds have short maturities and many others, because of their high coupons, are likely to be refunded and paid off in a few years. Overall, our WPPSS holdings are carried on our balance sheet at $247 million and have a market value of about $352 million.

We explained the reasons for our WPPSS purchases in the 1983 annual report, and are pleased to tell you that this commitment has worked out about as expected. At the time of purchase, most of our bonds were yielding around 17% after taxes and carried no ratings, which had been suspended. Recently, the bonds were rated AA- by Standard & Poor's. They now sell at levels only slightly below those enjoyed by top-grade credits.

In the 1983 report, we compared the economics of our WPPSS purchase to those involved in buying a business. As it turned out, this purchase actually worked out better than did the general run of business acquisitions made in 1983, assuming both are measured on the basis of unleveraged, after-tax returns achieved through 1988.

Our WPPSS experience, though pleasant, does nothing to alter our negative opinion about long-term bonds. It only makes us hope that we run into some other large stigmatized issue, whose troubles have caused it to be significantly misappraised by the market.

Arbitrage

In past reports we have told you that our insurance subsidiaries sometimes engage in arbitrage as an alternative to holding short-term cash equivalents. We prefer, of course, to make major long-term commitments, but we often have more cash than good ideas. At such times, arbitrage sometimes promises much greater returns than Treasury Bills and, equally important, cools any temptation we may have to relax our standards for long-term investments. (Charlie's signoff after we've talked about an arbitrage commitment is usually: "Okay, at least it will keep you out of bars.")

During 1988 we made unusually large profits from arbitrage, measured both by absolute dollars and rate of return. Our pre-tax gain was about $78 million on average invested funds of about $147 million.

This level of activity makes some detailed discussion of arbitrage and our approach to it appropriate. Once, the word applied only to the simultaneous purchase and sale of securities or foreign exchange in two different markets. The goal was to exploit tiny price differentials that might exist between, say, Royal Dutch stock trading in guilders in Amsterdam, pounds in London, and dollars in New York. Some people might call this scalping; it won't surprise you that practitioners opted for the French term, arbitrage.

Since World War I the definition of arbitrage — or "risk arbitrage," as it is now sometimes called — has expanded to include the pursuit of profits from an announced corporate event such as sale of the company, merger, recapitalization, reorganization, liquidation, self-tender, etc. In most cases the arbitrageur expects to profit regardless of the behavior of the stock market. The major risk he usually faces instead is that the announced event won't happen.

Some offbeat opportunities occasionally arise in the arbitrage field. I participated in one of these when I was 24 and working in New York for Graham-Newman Corp. Rockwood & Co., a Brooklyn-based chocolate products company of limited profitability, had adopted LIFO inventory valuation in 1941 when cocoa was selling for 5¢ per pound. In 1954 a temporary shortage of cocoa caused the price to soar to over 60¢. Consequently Rockwood wished to unload its valuable inventory — quickly, before the price dropped. But if the cocoa had simply been sold off, the company would have owed close to a 50% tax on the proceeds.

The 1954 Tax Code came to the rescue. It contained an arcane provision that eliminated the tax otherwise due on LIFO profits if inventory was distributed to shareholders as part of a plan reducing the scope of a corporation's business. Rockwood decided to terminate one of its businesses, the sale of cocoa butter, and said 13 million pounds of its cocoa bean inventory was attributable to that activity. Accordingly, the company offered to repurchase its stock in exchange for the cocoa beans it no longer needed, paying 80 pounds of beans for each share.

For several weeks I busily bought shares, sold beans, and made periodic stops at Schroeder Trust to exchange stock certificates for warehouse receipts. The profits were good and my only expense was subway tokens.

The architect of Rockwood's restructuring was an unknown, but brilliant Chicagoan, Jay Pritzker, then 32. If you're familiar with Jay's subsequent record, you won't be surprised to hear the action worked out rather well for Rockwood's continuing shareholders also. From shortly before the tender until shortly after it, Rockwood stock appreciated from 15 to 100, even though the company was experiencing large operating losses. Sometimes there is more to stock valuation than price-earnings ratios.

In recent years, most arbitrage operations have involved takeovers, friendly and unfriendly. With acquisition fever rampant, with anti-trust challenges almost non-existent, and with bids often ratcheting upward, arbitrageurs have prospered mightily. They have not needed special talents to do well; the trick, a la Peter Sellers in the movie, has simply been "Being There." In Wall Street the old proverb has been reworded: "Give a man a fish and you feed him for a day. Teach him how to arbitrage and you feed him forever." (If, however, he studied at the Ivan Boesky School of Arbitrage, it may be a state institution that supplies his meals.)

To evaluate arbitrage situations you must answer four questions: (1) How likely is it that the promised event will indeed occur? (2) How long will your money be tied up? (3) What chance is there that something still better will transpire — a competing takeover bid, for example? and (4) What will happen if the event does not take place because of anti-trust action, financing glitches, etc.?

Arcata Corp., one of our more serendipitous arbitrage experiences, illustrates the twists and turns of the business. On September 28, 1981 the directors of Arcata agreed in principle to sell the company to Kohlberg, Kravis, Roberts & Co. (KKR), then and now a major leveraged-buyout firm. Arcata was in the printing and forest products businesses and had one other thing going for it: In 1978 the U.S. Government had taken title to 10,700 acres of Arcata timber, primarily old-growth redwood, to expand Redwood National Park. The government had paid $97.9 million, in several installments, for this acreage, a sum Arcata was contesting as grossly inadequate. The parties also disputed the interest rate that should apply to the period between the taking of the property and final payment for it. The enabling legislation stipulated 6% simple interest; Arcata argued for a much higher and compounded rate.

Buying a company with a highly-speculative, large-sized claim in litigation creates a negotiating problem, whether the claim is on behalf of or against the company. To solve this problem, KKR offered $37.00 per Arcata share plus two-thirds of any additional amounts paid by the government for the redwood lands.

Appraising this arbitrage opportunity, we had to ask ourselves whether KKR would consummate the transaction since, among other things, its offer was contingent upon its obtaining "satisfactory financing." A clause of this kind is always dangerous for the seller: It offers an easy exit for a suitor whose ardor fades between proposal and marriage. However, we were not particularly worried about this possibility because KKR's past record for closing had been good.

We also had to ask ourselves what would happen if the KKR deal did fall through, and here we also felt reasonably comfortable: Arcata's management and directors had been shopping the company for some time and were clearly determined to sell. If KKR went away, Arcata would likely find another buyer, though of course, the price might be lower.

Finally, we had to ask ourselves what the redwood claim might be worth. Your Chairman, who can't tell an elm from an oak, had no trouble with that one: He coolly evaluated the claim at somewhere between zero and a whole lot.

We started buying Arcata stock, then around $33.50, on September 30 and in eight weeks purchased about 400,000 shares, or 5% of the company. The initial announcement said that the $37.00 would be paid in January, 1982. Therefore, if everything had gone perfectly, we would have achieved an annual rate of return of about 40% — not counting the redwood claim, which would have been frosting.

All did not go perfectly. In December it was announced that the closing would be delayed a bit. Nevertheless, a definitive agreement was signed on January 4. Encouraged, we raised our stake, buying at around $38.00 per share and increasing our holdings to 655,000 shares, or over 7% of the company. Our willingness to pay up — even though the closing had been postponed — reflected our leaning toward "a whole lot" rather than "zero" for the redwoods.

Then, on February 25 the lenders said they were taking a "second look" at financing terms " in view of the severely depressed housing industry and its impact on Arcata's outlook." The stockholders' meeting was postponed again, to April. An Arcata spokesman said he "did not think the fate of the acquisition itself was imperiled." When arbitrageurs hear such reassurances, their minds flash to the old saying: "He lied like a finance minister on the eve of devaluation."

On March 12 KKR said its earlier deal wouldn't work, first cutting its offer to $33.50, then two days later raising it to $35.00. On March 15, however, the directors turned this bid down and accepted another group's offer of $37.50 plus one-half of any redwood recovery. The shareholders okayed the deal, and the $37.50 was paid on June 4.

We received $24.6 million versus our cost of $22.9 million; our average holding period was close to six months. Considering the trouble this transaction encountered, our 15% annual rate of return — excluding any value for the redwood claim — was more than satisfactory.

But the best was yet to come. The trial judge appointed two commissions, one to look at the timber's value, the other to consider the interest rate questions. In January 1987, the first commission said the redwoods were worth $275.7 million and the second commission recommended a compounded, blended rate of return working out to about 14%.

In August 1987 the judge upheld these conclusions, which meant a net amount of about $600 million would be due Arcata. The government then appealed. In 1988, though, before this appeal was heard, the claim was settled for $519 million. Consequently, we received an additional $29.48 per share, or about $19.3 million. We will get another $800,000 or so in 1989.

Berkshire's arbitrage activities differ from those of many arbitrageurs. First, we participate in only a few, and usually very large, transactions each year. Most practitioners buy into a great many deals — perhaps 50 or more per year. With that many irons in the fire, they must spend most of their time monitoring both the progress of deals and the market movements of the related stocks. This is not how Charlie nor I wish to spend our lives. (What's the sense in getting rich just to stare at a ticker tape all day?)

Because we diversify so little, one particularly profitable or unprofitable transaction will affect our yearly result from arbitrage far more than it will the typical arbitrage operation. So far, Berkshire has not had a really bad experience. But we will — and when it happens we'll report the gory details to you.

The other way we differ from some arbitrage operations is that we participate only in transactions that have been publicly announced. We do not trade on rumors or try to guess takeover candidates. We just read the newspapers, think about a few of the big propositions, and go by our own sense of probabilities.

At yearend, our only major arbitrage position was 3,342,000 shares of RJR Nabisco with a cost of $281.8 million and a market value of $304.5 million. In January we increased our holdings to roughly four million shares and in February we eliminated our position. About three million shares were accepted when we tendered our holdings to KKR, which acquired RJR, and the returned shares were promptly sold in the market. Our pre-tax profit was a better-than-expected $64 million.

Earlier, another familiar face turned up in the RJR bidding contest: Jay Pritzker, who was part of a First Boston group that made a tax-oriented offer. To quote Yogi Berra; "It was déjà vu all over again."

During most of the time when we normally would have been purchasers of RJR, our activities in the stock were restricted because of Salomon's participation in a bidding group. Customarily, Charlie and I, though we are directors of Salomon, are walled off from information about its merger and acquisition work. We have asked that it be that way: The information would do us no good and could, in fact, occasionally inhibit Berkshire's arbitrage operations.

However, the unusually large commitment that Salomon proposed to make in the RJR deal required that all directors be fully informed and involved. Therefore, Berkshire's purchases of RJR were made at only two times: first, in the few days immediately following management's announcement of buyout plans, before Salomon became involved; and considerably later, after the RJR board made its decision in favor of KKR. Because we could not buy at other times, our directorships cost Berkshire significant money.

Considering Berkshire's good results in 1988, you might expect us to pile into arbitrage during 1989. Instead, we expect to be on the sidelines.

One pleasant reason is that our cash holdings are down — because our position in equities that we expect to hold for a very long time is substantially up. As regular readers of this report know, our new commitments are not based on a judgment about short-term prospects for the stock market. Rather, they reflect an opinion about long-term business prospects for specific companies. We do not have, never have had, and never will have an opinion about where the stock market, interest rates, or business activity will be a year from now.

Even if we had a lot of cash we probably would do little in arbitrage in 1989. Some extraordinary excesses have developed in the takeover field. As Dorothy says: "Toto, I have a feeling we're not in Kansas any more."

We have no idea how long the excesses will last, nor do we know what will change the attitudes of government, lender and buyer that fuel them. But we do know that the less the prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs. We have no desire to arbitrage transactions that reflect the unbridled — and, in our view, often unwarranted — optimism of both buyers and lenders. In our activities, we will heed the wisdom of Herb Stein: "If something can't go on forever, it will end."

Efficient Market Theory

The preceding discussion about arbitrage makes a small discussion of "efficient market theory" (EMT) also seem relevant. This doctrine became highly fashionable — indeed, almost holy scripture — in academic circles during the 1970s. Essentially, it said that analyzing stocks was useless because all public information about them was appropriately reflected in their prices. In other words, the market always knew everything. As a corollary, the professors who taught EMT said that someone throwing darts at the stock tables could select a stock portfolio having prospects just as good as one selected by the brightest, most hard-working security analyst. Amazingly, EMT was embraced not only by academics, but by many investment professionals and corporate managers as well. Observing correctly that the market was *frequently* efficient, they went on to conclude incorrectly that it was *always* efficient. The difference between these propositions is night and day.

In my opinion, the continuous 63-year arbitrage experience of Graham-Newman Corp. Buffett Partnership, and Berkshire illustrates just how foolish EMT is. (There's plenty of other evidence, also.) While at Graham-Newman, I made a study of its earnings from arbitrage during the entire 1926-1956 lifespan of the company. Unleveraged returns averaged 20% per year. Starting in 1956, I applied Ben Graham's arbitrage principles, first at Buffett Partnership and then Berkshire. Though I've not made an exact calculation, I have done enough work to know that the 1956-1988 returns averaged well over 20%. (Of course, I operated in an environment far more favorable than Ben's; he had 1929-1932 to contend with.)

All of the conditions are present that are required for a fair test of portfolio performance: (1) the three organizations traded hundreds of different securities while building this 63-year record; (2) the results are not skewed by a few fortunate experiences; (3) we did not have to dig for obscure facts or develop keen insights about products or managements — we simply acted on highly-publicized events; and (4) our arbitrage positions were a clearly identified universe — they have not been selected by hindsight.

Over the 63 years, the general market delivered just under a 10% annual return, including dividends. That means $1,000 would have grown to $405,000 if all income had been reinvested. A 20% rate of return, however, would have produced $97 million. That strikes us as a statistically-significant differential that might, conceivably, arouse one's curiosity.

Yet proponents of the theory have never seemed interested in discordant evidence of this type. True, they don't talk quite as much about their theory today as they used to. But no one, to my knowledge, has ever said he was wrong, no matter how many thousands of students he has sent forth misinstructed. EMT, moreover, continues to be an integral part of the investment curriculum at major business schools. Apparently, a reluctance to recant, and thereby to demystify the priesthood, is not limited to theologians.

Naturally the disservice done students and gullible investment professionals who have swallowed EMT has been an extraordinary service to us and other followers of Graham. In any sort of a contest — financial, mental, or physical — it's an enormous advantage to have opponents who have been taught that it's useless to even try. From a selfish point of view, Grahamites should probably endow chairs to ensure the perpetual teaching of EMT.

All this said, a warning is appropriate. Arbitrage has looked easy recently. But this is not a form of investing that guarantees profits of 20% a year or, for that matter, profits of any kind. As noted, the market is reasonably efficient much of the time: For every arbitrage opportunity we seized in that 63-year period, many more were foregone because they seemed properly-priced.

An investor cannot obtain superior profits from stocks by simply committing to a specific investment category or style. He can earn them only by carefully evaluating facts and continuously exercising discipline. Investing in arbitrage situations, per se, is no better a strategy than selecting a portfolio by throwing darts.

New York Stock Exchange Listing

Berkshire's shares were listed on the New York Stock Exchange on November 29, 1988. On pages 50-51 we reproduce the letter we sent to shareholders concerning the listing.

Let me clarify one point not dealt with in the letter: Though our round lot for trading on the NYSE is ten shares, any number of shares from one on up can be bought or sold.

As the letter explains, our primary goal in listing was to reduce transaction costs, and we believe this goal is being achieved. Generally, the spread between the bid and asked price on the NYSE has been well below the spread that prevailed in the over-the-counter market.

Henderson Brothers, Inc., the specialist in our shares, is the oldest continuing specialist firm on the Exchange; its progenitor, William Thomas Henderson, bought his seat for $500 on September 8, 1861. (Recently, seats were selling for about $625,000.) Among the 54 firms acting as specialists, HBI ranks second in number of stocks assigned, with 83. We were pleased when Berkshire was allocated to HBI, and have been delighted with the firm's performance. Jim Maguire, Chairman of HBI, personally manages the trading in Berkshire, and we could not be in better hands.

In two respects our goals probably differ somewhat from those of most listed companies. First, we do not want to maximize the price at which Berkshire shares trade. We wish instead for them to trade in a narrow range centered at intrinsic business value (which we hope increases at a reasonable — or, better yet, unreasonable — rate). Charlie and I are bothered as much by significant overvaluation as significant undervaluation. Both extremes will inevitably produce results for many shareholders that will differ sharply from Berkshire's business results. If our stock price instead consistently mirrors business value, each of our shareholders will receive an investment result that roughly parallels the business results of Berkshire during his holding period.

Second, we wish for very little trading activity. If we ran a private business with a few passive partners, we would be disappointed if those partners, and their replacements, frequently wanted to leave the partnership. Running a public company, we feel the same way.

Our goal is to attract long-term owners who, at the time of purchase, have no timetable or price target for sale but plan instead to stay with us indefinitely. We don't understand the CEO who wants lots of stock activity, for that can be achieved only if many of his owners are constantly exiting. At what other organization — school, club, church, etc. — do leaders cheer when members leave? (However, if there were a broker whose livelihood depended upon the membership turnover in such organizations, you could be sure that there would be at least one proponent of activity, as in: "There hasn't been much going on in Christianity for a while; maybe we should switch to Buddhism next week.")

Of course, some Berkshire owners will need or want to sell from time to time, and we wish for good replacements who will pay them a fair price. Therefore we try, through our policies, performance, and communications, to attract new shareholders who understand our operations, share our time horizons, and measure us as we measure ourselves. If we can continue to attract this sort of shareholder — and, just as important, can continue to be uninteresting to those with short-term or unrealistic expectations — Berkshire shares should consistently sell at prices reasonably related to business value.

David L. Dodd

Dave Dodd, my friend and teacher for 38 years, died last year at age 93. Most of you don't know of him. Yet any long-time shareholder of Berkshire is appreciably wealthier because of the indirect influence he had upon our company.

Dave spent a lifetime teaching at Columbia University, and he co-authored *Security Analysis* with Ben Graham. From the moment I arrived at Columbia, Dave personally encouraged and educated me; one influence was as important as the other. Everything he taught me, directly or through his book, made sense. Later, through dozens of letters, he continued my education right up until his death.

I have known many professors of finance and investments but I have never seen any, except for Ben Graham, who was the match of Dave. The proof of his talent is the record of his students: No other teacher of investments has sent forth so many who have achieved unusual success.

When students left Dave's classroom, they were equipped to invest intelligently for a lifetime because the principles he taught were simple, sound, useful, and enduring. Though these may appear to be unremarkable virtues, the teaching of principles embodying them has been rare.

It's particularly impressive that Dave could practice as well as preach. Just as Keynes became wealthy by applying his academic ideas to a very small purse, so, too, did Dave. Indeed, his financial performance far outshone that of Keynes, who began as a market-timer (leaning on business- and credit-cycle theory) and converted, after much thought, to value investing. Dave was right from the start.

In Berkshire's investments, Charlie and I have employed the principles taught by Dave and Ben Graham. Our prosperity is the fruit of their intellectual tree.

Miscellaneous

We hope to buy more businesses that are similar to the ones we have, and we can use some help. If you have a business that fits the following criteria, 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 "turnaround" 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.

Our favorite form of purchase is one fitting the Blumkin-Friedman-Heldman mold. In cases like these, the company's owner-managers wish to generate significant amounts of cash, sometimes for themselves, but often for their families or inactive shareholders. However, these managers also wish to remain significant owners who continue to run their companies just as they have in the past. We think we offer a particularly good fit for owners with these objectives and invite potential sellers to check us out by contacting people with whom we have done business in the past.

Charlie and I frequently get approached about acquisitions that don't come close to meeting our tests: We've found that if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels. Our interest in new ventures, turnarounds, or auction-like sales can best be expressed by another Goldwynism: "Please include me out."

Besides being interested in the purchase of businesses as described above, we are also interested in the negotiated purchase of large, but not controlling, blocks of stock comparable to those we hold in Cap Cities and Salomon. We have a special interest in purchasing convertible preferreds as a long-term investment, as we did at Salomon.

* * *

We received some good news a few weeks ago: Standard & Poor's raised our credit rating to AAA, which is the highest rating it bestows. Only 15 other U.S. industrial or property-casualty companies are rated AAA, down from 28 in 1980.

Corporate bondholders have taken their lumps in the past few years from "event risk." This term refers to the overnight degradation of credit that accompanies a heavily-leveraged purchase or recapitalization of a business whose financial policies, up to then, had been conservative. In a world of takeovers inhabited by few owner-managers, most corporations present such a risk. Berkshire does not. Charlie and I promise bondholders the same respect we afford shareholders.

* * *

About 97.4% of all eligible shares participated in Berkshire's 1988 shareholder-designated contributions program. Contributions made through the program were $5 million, and 2,319 charities were recipients. If we achieve reasonable business results, we plan to increase the per-share contributions in 1989.

We urge new shareholders to read the description of our shareholder-designated contributions program that appears on pages 48-49. 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 the nominee name of a broker, bank or depository. Shares not so registered on September 30, 1989 will be ineligible for the 1989 program.

* * *

Berkshire's annual meeting will be held in Omaha on Monday, April 24, 1989, and I hope you will come. The meeting provides the forum for you to ask any owner-related questions you may have, and we will keep answering until all (except those dealing with portfolio activities or other proprietary information) have been dealt with.

After the meeting we will have several buses available to take you to visit Mrs. B at The Nebraska Furniture Mart and Ike Friedman at Borsheim's. Be prepared for bargains.

Out-of-towners may prefer to arrive early and visit Mrs. B during the Sunday store hours of noon to five. (These Sunday hours seem ridiculously short to Mrs. B, who feels they scarcely allow her time to warm up; she much prefers the days on which the store remains open from 10 a.m. to 9 p.m.) Borsheims, however, is not open on Sunday.

Ask Mrs. B the secret of her astonishingly low carpet prices. She will confide to you — as she does to everyone — how she does it: "I can sell so cheap 'cause I work for this dummy who doesn't know anything about carpet."

Warren E. Buffett
Chairman of the Board

February 28, 1989

BERKSHIRE HATHAWAY INC.
and Subsidiaries
CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	December 31, 1988	December 31, 1987*
ASSETS		
Cash and cash equivalents	$ 265,081	$ 231,962
Investments:		
Salomon Inc preferred stock	700,000	700,000
Other obligations with fixed maturities, principally bonds	1,115,321	1,371,645
Marketable equity securities	3,558,724	2,362,445
Loans and accounts receivable	579,910	577,949
Inventories	167,293	154,288
Properties and equipment	194,390	202,459
Unamortized goodwill	121,394	124,195
Other assets	114,735	138,292
	$6,816,848	$5,863,235
LIABILITIES AND SHAREHOLDERS' EQUITY		
Losses and loss adjustment expenses	$1,407,189	$1,260,422
Unearned premiums	241,818	341,344
Savings accounts	286,909	286,211
Accounts payable, accruals and other liabilities	325,514	280,088
Income taxes	598,905	506,499
Term debt and other borrowings	480,009	289,886
	3,340,344	2,964,450
Minority shareholders' interests	66,396	57,126
Shareholders' equity:		
Common stock of $5 par value. Authorized 1,500,000 shares; issued 1,375,202 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	1,274,657	1,104,123
Retained earnings	2,013,491	1,614,221
	3,452,401	2,882,597
Less common stock in treasury, at cost (1988 — 228,761 shares, 1987 — 228,274 shares)	42,293	40,938
Total shareholders' equity	3,410,108	2,841,659
	$6,816,848	$5,863,235

**Restated — See Note 1(b)*

See accompanying Notes to Consolidated Financial Statements

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

	Year Ended December 31, 1988	1987*	1986*
Revenues:			
Sales and service revenues	$1,407,642	$1,326,829	$1,219,252
Insurance premiums earned	584,235	824,895	823,884
Interest and dividend income	314,251	237,319	181,992
Sundry income	27,094	13,901	6,316
	2,333,222	2,402,944	2,231,444
Cost and expenses:			
Cost of products and services sold	753,845	705,203	651,717
Insurance losses and loss adjustment expenses	437,695	661,146	655,758
Insurance underwriting expenses	157,621	219,178	223,970
Selling, general and administrative expenses	495,331	488,307	446,633
Interest expense	70,280	47,437	55,402
	1,914,772	2,121,271	2,033,480
Earnings from operations including minority interest in subsidiaries, before applicable income taxes and before realized investment gain	418,450	281,673	197,964
Income taxes applicable to above	96,599	60,771	61,300
	321,851	220,902	136,664
Minority interest applicable to above	8,410	6,156	5,200
Earnings before realized investment gain	313,441	214,746	131,464
Realized investment gain, net	85,829	19,806	150,897
Net earnings	$ 399,270	$ 234,552	$ 282,361
Average shares outstanding	1,146,575	1,146,909	1,146,909
Per share:			
Earnings before realized investment gain	$ 273.37	$ 187.24	$ 114.62
Net earnings	348.23	204.51	246.19

*Restated — See Note 1(b)

See accompanying Notes to Consolidated Financial Statements

BERKSHIRE HATHAWAY INC.
and Subsidiaries
CONSOLIDATED STATEMENTS OF CASH FLOWS
(dollars in thousands)

	Year Ended December 31,		
	1988	1987	1986
Cash flows from operating activities:			
Net Income	$ 399,270	$ 234,552	$ 282,361
Adjustments to reconcile net income to cash flows from operating activities:			
Depreciation and amortization	29,808	29,683	28,519
Realized investment gain	(131,671)	(28,839)	(220,765)
Minority interests	10,060	6,420	6,063
Increase (decrease) in income taxes payable	3,643	(30,937)	(66,504)
Increase in losses and loss adjustment expenses	146,767	400,194	448,923
Increase (decrease) in unearned premiums	(99,526)	(73,642)	185,546
(Increase) decrease in deferred acquisition costs	11,783	21,907	(27,778)
Other	(6,253)	47,402	(2,923)
Net cash flows from operating activities	363,881	606,740	633,442
Cash flows from investing activities:			
Purchase of Salomon Inc preferred stock	—	(700,000)	—
Purchase of other fixed maturity investments	(109,245)	(529,290)	(729,036)
Purchase of Capital Cities/ABC, Inc. common stock	—	—	(517,500)
Purchases of other marketable equity securities	(1,708,971)	(550,112)	(725,594)
Proceeds on sales and maturities of fixed maturity investments	391,455	297,983	170,977
Proceeds on sales of marketable equity securities	878,228	607,080	942,509
Loans originated in finance businesses	(103,602)	(177,840)	(153,839)
Principal collection on loans	111,745	123,297	109,761
Acquisition of businesses	—	—	(299,915)*
Other	21,144	(15,351)	(37,988)
Net cash flows from investing activities	(519,246)	(944,233)	(1,240,625)
Cash flows from financing activities:			
Proceeds from borrowings	250,000	50,075	118,590
Repayments of borrowings	(59,877)	(20,359)	(76,690)
Net increase (decrease) in passbook, money market and interest bearing checking accounts	(4,928)	3,415	8,267
Increase in certificate deposit accounts	193,770	207,110	233,494
Payments for maturing certificate accounts	(188,144)	(206,672)	(228,450)
Other	(2,337)	(4,393)	(934)
Net cash flows from financing activities	188,484	29,176	54,277
Increase (decrease) in cash and equivalents	33,119	(308,317)	(552,906)
Cash and equivalents at beginning of year	231,962	540,279	1,093,185
Cash and equivalents at end of year	$ 265,081	$ 231,962	$ 540,279
Other cash flow information:			
Income taxes paid	$ 137,148	$ 100,778	$ 193,831
Interest paid	61,798	46,067	54,336

*In conjunction with business acquisitions in 1986, the Company assumed liabilities of $254,431.

See accompanying Notes to Consolidated Financial Statements

BERKSHIRE HATHAWAY INC.
and Subsidiaries
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 1988

(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 its subsidiaries, in accordance with the pronounced requirements of Statement of Financial Accounting Standards No. 94, first adopted by Berkshire in these statements.

(b) Restatements and Reclassifications

Berkshire's prior period consolidated financial statements have been restated to include in consolidation the accounts of all subsidiaries, and reclassifications in prior year data have been made where required for conformity. Finance-type subsidiaries previously accounted for pursuant to the equity method of accounting but now consolidated are Mutual Savings and Loan Association ("Mutual") and its subsidiary plus Scott Fetzer Financial Group, Inc. ("SFFG") and its subsidiaries. Mutual is a California chartered savings and loan association and SFFG is in the business of lending and finance.

Consolidated Statements of Cash Flows are included in this report. With respect to prior periods presented, these replace previously issued Statements of Changes in Financial Position.

(c) Cash Equivalents

Cash equivalents consist of funds invested in money market accounts and in highly liquid investments with a maturity of three months or less when purchased.

(d) Investments

The investment in Salomon Inc redeemable preferred stock is carried at cost. See Note 2.

Investments in other obligations with fixed maturities, principally bonds, are stated at aggregate purchased cost adjusted, where appropriate, for accretion of discount or amortization of premium. The aggregate fair market value of this category of investments was $1,264,078 at December 31, 1988, and $1,493,641 at December 31, 1987.

Investments in marketable equity securities — common stocks and nonredeemable preferred stocks — held by members of the Berkshire Hathaway Insurance Group are carried in Berkshire's Consolidated Balance Sheets at market value. See Note 1(j) with respect to income taxes deemed applicable to unrealized appreciation included in carrying value. Investments by the Company and by non-insurance subsidiaries are carried at cost, which in the aggregate is not less than market value. See Note 5.

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 taxes, identified cost is used.

(e) 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.

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

(f) 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 cost 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.

(g) Losses and Loss Adjustment Expenses

Liability for losses and loss adjustment expenses is determined on the basis of estimates of unpaid amounts with respect to both reported and incurred but not reported losses. Provisions are intended to cover ultimate payment amounts less amounts recoverable on account of reinsurance, except that provisions for periodic payment obligations ("structured settlements") are established at discounted present value of expected ultimate payment amounts.

Present value of expected ultimate payment amounts for structured settlements was determined for financial reporting purposes to be $128,901 as of December 31, 1988 and $66,285 as of December 31, 1987 applying, as present value discount rates, the market interest rates at contract inception dates — the weighted average of which was 9.5% as of December 31, 1988. Present value of liabilities for structured settlements was determined for statutory and tax reporting purposes to be $213,746 and $110,010, respectively as of December 31, 1988 and 1987, applying discount rates prescribed by insurance regulatory authority — 5% for contracts incepting after 1986, and 7% with respect to contracts dated prior to 1987.

(h) 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 unearned premiums ceded to reinsurers.

Policyholder dividends, immaterial in amount (less than $5,000 per year for each of the past three years), incurred with respect to participating policies are reflected in the accompanying Consolidated Statements of Earnings as a deduction from earned premiums.

(j) Income Taxes

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 Company's consolidated federal income tax returns, giving rise to recognition in the financial statements to deferred and prepaid income taxes.

The liability for income taxes in the Consolidated Balance Sheets includes taxes deemed applicable to unrealized appreciation included in carrying value of marketable equity securities. Such taxes were accrued at a rate of 34% relative to increases in unrealized appreciation during 1987 and 1988 and at the rate of 28% relative to appreciation that arose in years prior to 1987.

The Financial Accounting Standards Board ("FASB") issued Statement No. 96 "Accounting for Income Taxes" which the Company has not yet implemented. Presently the FASB requires implementation no later than 1990. See note 8.

(2) Investment in Cumulative Convertible Preferred Stock of Salomon Inc

On October 1, 1987 subsidiaries of Berkshire purchased 700,000 shares of a new issue of 9% Cumulative Convertible Preferred Stock of Salomon Inc ("Salomon"). These shares were purchased for cash at their par value of one thousand dollars per share and $700,000 in the aggregate. The investment is carried in the Consolidated Balance Sheet at cost. Market quotations are not available with respect to these shares. A committee of the Company's board of directors has determined that the fair market value of the shares at December 31, 1988 was, in an aggregate amount not material to the Company, somewhat in excess of their purchased cost.

Each share of the issue is entitled to 26.31579 votes on all matters submitted to a vote of Salomon's shareholders, with the Preferred Shares voting together as one class with the Salomon common shares. At December 31, 1988, the preferred shares possessed approximately 12% of the voting rights of the class. On October 31, 1990, each preferred share becomes convertible into 26.31579 fully paid common shares of Salomon. Annually on each October 31, commencing in 1995, Salomon will redeem at cost 140,000 of the shares (or such fewer number as are then outstanding).

(3) Investment in Shares of Capital Cities/ABC, Inc.

Common shares of Capital Cities/ABC, Inc. ("Capital Cities") owned by Berkshire subsidiaries possessed approximately 17% of the voting rights of all Capital Cities shares outstanding at December 31, 1988. The shares are held subject to terms of an Agreement which grants 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.

(4) Investment in GEICO Corporation

Subsidiaries of Berkshire, at both December 31, 1988 and at December 31, 1987, owned 6,850,000 shares of common stock of GEICO Corporation. The shares possessed approximately 44% of the voting rights of all GEICO shares outstanding at December 31, 1988, but Berkshire maintains an independent proxy arrangement for voting of the shares as required by Order of GEICO's domiciliary insurance supervisory authority. The Order, dating from Berkshire subsidiaries' major purchase of the shares in 1976, 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. Because the Order divests Berkshire of its voting rights with respect to the shares, Berkshire does not use the equity method of accounting for its investment in GEICO.

Notes to Consolidated Financial Statements *(Continued)*
(dollars in thousands except per share amounts)

(5) Investments in Marketable Equity Securities

Aggregate data with respect to the consolidated investment in marketable equity securities is shown below as of the dates indicated. See Note 1(d) as to methods applied to determine carrying value of these securities.

	December 31, 1988			
	Cost	Unrealized Gain	Market	Carrying Value
Common stock of:				
Capital Cities/ABC, Inc.	$ 517,500	$ 569,250	$1,086,750	$1,077,262
The Coca-Cola Company	592,540	39,908	632,448	632,448
GEICO Corporation	45,713	803,687	849,400	849,400
RJR Nabisco Inc.	281,765	22,775	304,540	304,180
The Washington Post Company	9,731	354,395	364,126	364,126
All other marketable equity securities	288,000	97,653	385,653	331,308
	$1,735,249	$1,887,668	$3,622,917	$3,558,724

	December 31, 1987			
	Cost	Unrealized Gain	Market	Carrying Value
Common stock of:				
Capital Cities/ABC, Inc.	$ 517,500	$ 517,500	$1,035,000	$1,026,375
GEICO Corporation	45,713	711,212	756,925	756,925
The Washington Post Company	9,731	313,361	323,092	323,092
All other marketable equity securities	225,511	36,956	262,467	256,053
	$ 798,455	$1,579,029	$2,377,484	$2,362,445

Unrealized gain is shown net of nominal unrealized loss as to certain stocks included above in the category captioned "All other marketable equity securities."

(6) Loans and Accounts Receivable

Loans and accounts receivable represent the following:

	Dec. 31, 1988	Dec. 31, 1987
Trade accounts receivable	$234,009	$223,298
Loans of Mutual, principally real estate	136,970	139,438
Installment receivables purchased by SFFG	69,229	84,091
Due Insurance Group members, principally premiums	63,275	81,878
Investment income due and accrued	43,168	43,975
Amounts due from sales of securities	33,259	5,269
	$579,910	$577,949

(7) Income Taxes

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

	Dec. 31, 1988	Dec. 31, 1987
Payable currently	$ 46,758	$ 34,071
Deferred, relating to unrealized appreciation of marketable equity securities	548,470	459,707
Deferred, net of prepaid, arising from timing differences	3,677	12,721
	$598,905	$506,499

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

Applicable to	1988	1987	1986
Operating earnings	$ 96,599	$ 60,771	$ 61,300
Realized investment gain	44,192	9,070	68,954
	$140,791	$ 69,841	$130,254

These taxes are comprised of:

	1988	1987	1986
Federal	$122,492	$ 56,899	$116,254
State	15,871	11,551	13,050
Foreign	2,428	1,391	950
	$140,791	$ 69,841	$130,254
Taxes payable currently	$149,835	$122,653	$110,620
Increase (decrease) in net deferred taxes	(9,044)	(52,812)	19,634
	$140,791	$ 69,841	$130,254

The increase (decrease) in net deferred taxes represent the tax effects of timing differences as follows:

Applicable to	1988	1987	1966
Deferred insurance premium acquisition costs	$ (7,377)	$ (13,577)	$ 12,778
Structured settlements and portfolio reinsurance liabilities	6,902	4,714	2,555
Discounting of losses and loss adjustment expense reserves	(10,988)	(37,692)	—
Deferred gross profit on installment sales	(4,610)	(8,745)	(2,836)
Other, net	7,029	2,488	7,137
	$ (9,044)	$ (52,812)	$ 19,634

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

	1988	1987	1986
Net earnings including minority interest, before applicable income taxes	$550,121	$310,514	$418,729
Hypothetical amounts applicable to above computed at the Federal statutory rate (34% in 1988, 40% in 1987 and 46% in 1986)	$187,041	$124,206	$192,615
Decreases, resulting from:			
Tax-exempt interest income	(33,477)	(40,501)	(34,192)
Dividends received deduction	(21,461)	(10,830)	(8,522)
Rate differentials relating to realized investment gains	—	(3,079)	(31,878)
Fresh start adjustment related to discounting of loss and loss adjustment expense reserves	(5,120)	(8,241)	—
State income taxes, less Federal income tax benefit	10,597	6,931	7,048
Net other differences	3,211	1,355	5,183
Total income taxes	$140,791	$ 69,841	$130,254

Notes to Consolidated Financial Statements *(Continued)*
(dollars in thousands except per share amounts)

(8) Prospective Change in Method of Accounting for Income Taxes

The Company intends to implement in 1990 the change in accounting for income taxes, as mandated by the Financial Accounting Standards Board. Berkshire management believes that if the changed methods were applied to its December 31, 1988 data, its consolidated shareholders' equity would be reduced by as much as $74,000. The reduction would have been accomplished by a reduction of reported earnings and was determined from the following:

Changed rates applied in computing income taxes deemed applicable to unrealized appreciation of marketable equity securities	$71,000
Tax benefits yet to be recognized from "fresh start"	(34,000)
Deferred taxes attributable to remaining book and tax basis differences that arose in accounting for business acquisitions	38,000
Other	(1,000)
	$74,000

Figures in this note are based on data that will change by the date Berkshire actually implements the changed methods.

(9) Term Debt and Other Borrowings

The following table sets forth the term debt and other borrowings of the Company and its subsidiaries at December 31, 1988 and 1987.

Company	*1988*	*1987*
10% Debentures due January 1, 2018, redeemable through operation of a sinking fund which calls for annual repayments of $7,500 beginning in 1999	$150,000	$ —
9¾% Debentures due January 15, 2018, redeemable through operation of a sinking fund which calls for annual repayments of $5,000 beginning in 1999	100,000	—
8.97% Fixed Rate loan due November 3, 1988	—	50,000
Other notes, payable through 1993	11,316	13,565
	261,316	63,565
Subsidiaries		
8.125% Notes, payable in 1996	120,000	120,000
10% Notes, payable in annual installments of $2,625 through 1997 with a final payment of $2,750 on August 31, 1998	26,375	29,000
9½% Notes, payable in annual installments of $2,500 through 1998	25,000	27,500
10⅛% Notes, payable in 1991	25,000	25,000
Other notes maturing through 2007	22,318	24,821
	$480,009	$289,886

Covenants of various borrowing Agreements to which the Company or its subsidiaries are parties are not materially restrictive.

Principal payments on borrowings outstanding at December 31, 1988 are required during the succeeding five years as follows:

1989	$12,852
1990	7,805
1991	32,798
1992	7,813
1993	7,799

(10) Shareholders' Equity Accounts

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

	Net Unrealized Appreciation	*Retained Earnings*	*Treasury Stock*
Balance at December 28, 1985	$ 664,707	$1,097,308	$ 40,938
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	40,938
Increase during 1987 in unrealized appreciation included in carrying value of marketable equity securities	349,147		
Change during 1987 in deemed applicable income taxes	(119,837)		
Net earnings 1987		234,552	
Balance at December 31, 1987	1,104,123	1,614,221	40,938
Increase during 1988 in unrealized appreciation included in carrying value of marketable equity securities	259,486		
Change during 1988 in deemed applicable income taxes	(88,763)		
Increase in minority shareholders' interest in unrealized appreciation	(189)		
Net earnings 1988		399,270	
Value of Berkshire stock received in connection with termination of pension plans			1,355
Balance at December 31, 1988	$1,274,657	$2,013,491	$ 42,293

(11) Interest and Dividend Income

Interest and dividend income for each of the past three years was comprised of the following:

	1988	*1987*	*1986*
Dividends:			
Capital Cities/ABC, Inc.	$ 600	$ 600	$ 600
The Coca-Cola Company	4,393	—	—
GEICO Corporation	11,234	9,316	7,398
Salomon Inc.	63,000	15,750	—
The Washington Post Company	2,695	2,212	1,935
All Others	16,695	10,401	12,113
Total dividends	98,617	38,279	22,046
Interest from:			
Investments	164,499	147,769	115,730
Loans and financed receivables	51,135	51,271	44,216
Interest and dividend income	$314,251	$237,319	$181,992

Notes to Consolidated Financial Statements *(Continued)*
(dollars in thousands except per share amounts)

(12) Sundry Income

Sundry income for 1988 includes approximately $16,366 which represents the approximate fair value of cash and securities that reverted to the Company and to certain of its subsidiaries upon termination of overfunded defined benefit pension plans.

(13) Interest Expense

Interest expense is comprised of interest on savings accounts of Mutual, plus interest on debt as follows:

	1988	1987	1986
Savings accounts of Mutual	$20,579	$20,903	$22,275
Debt of SFFG	14,088	15,060	9,235
Other debt	35,613	11,474	23,892
	$70,280	$47,437	$55,402

(14) Dividend Restrictions — Insurance Subsidiaries

Payments of dividends by Insurance Group members are restricted by insurance statutes and regulations. Without prior regulatory approval in 1989, Berkshire can receive up to approximately $350,000 as dividends from subsidiaries that are members of the Insurance Group.

Combined shareholder's equity of insurance subsidiaries, determined pursuant to statutory accounting rules (Statutory Surplus as Regards Policyholders) was approximately $3,600,000 and $2,800,000 at December 31, 1988 and 1987, respectively. These amounts exceeded the corresponding amounts determined on the basis of generally accepted accounting principles by approximately $500,000 at December 31, 1988 and $400,000 at December 31, 1987. The principle difference is represented by deferred income tax liabilities recognized for financial reporting purposes but ignored for statutory reporting purposes.

(15) Business Segment Data

Berkshire had seven reportable business segments in 1988. The principal activity/product/service of each is described below:

Segment	Activity/product/service
Insurance	Property/casualty insurance and reinsurance.
Candy	Boxed chocolates and other confectionary products.
Newspaper	Publication of the *Buffalo News*, a daily and Sunday newspaper.
Retailing of home furnishings	Carpet, furniture, appliances, electronics and related products.
Encyclopedias, other reference materials	Composition, publication and marketing of *World Book* encyclopedias and other educational and reference works.
Home cleaning systems	Manufacture and distribution of principally *Kirby* branded home cleaning systems and products.
Uniform manufacturing and distribution	Manufacture and distribution at retail of uniforms, trousers, jackets, shirts and caps.

The tables which follow reflect data for those segments for each of the three most recent years.

(15) Business Segment Data *(continued)*

Revenues

	1988	1987	1986
Insurance	$ 816,142	$ 977,890	$ 931,379
Candy	168,166	157,391	151,861
Newspaper	131,664	122,955	114,267
Retailing of home furnishings	152,541	145,997	135,501
Encyclopedias, other reference materials	337,990	325,772	285,356
Home cleaning systems	144,145	129,678	126,812
Uniform manufacturing and distribution	92,514	74,734	41,355
Revenues not identified with segments	490,060	468,527	444,913
	$2,333,222	$2,402,944	$2,231,444

Operating Profit Before Taxes

	1988	1987	1986
Insurance	$ 220,169	$ 97,054	$ 51,299
Candy	31,498	30,718	29,373
Newspaper	41,830	38,811	34,137
Retailing of home furnishings	17,994	16,328	17,176
Encyclopedias, other reference materials	27,639	25,494	20,534
Home cleaning systems	27,210	23,325	20,019
Uniform manufacturing and distribution	13,425	12,613	7,988
Pre-tax operating profits not identified with segments	83,018	57,122	48,074
Unallocated corporate costs	(8,720)	(8,318)	(6,745)
Interest on debt, except finance companies' debt	(35,613)	(11,474)	(23,891)
	$ 418,450	$ 281,673	$ 197,964

Realized investment gains are not reflected in this table.

Capital Expenditures

	1988	1987	1986
Insurance	$ 838	$ 804	$ 607
Candy	3,509	4,758	4,138
Newspaper	988	1,266	764
Retailing of home furnishings	2,037	3,103	3,771
Encyclopedias, other reference materials	329	376	307
Home cleaning systems	2,370	1,320	1,562
Uniform manufacturing and distribution	2,203	981	325
Other	5,418	5,155	8,726
	$ 17,692	$ 17,763	$ 20,200

Expenditures which were part of business acquisitions are excluded.

Notes to Consolidated Financial Statements *(Continued)*
(dollars in thousands except per share amounts)

(15) Business Segment Data *(continued)*

Depreciation and Amortization of Tangible Assets

	1988	1987	1986
Insurance	$ 722	$ 648	$ 545
Candy	3,392	3,200	2,956
Newspaper	2,836	2,909	2,899
Retailing of home furnishings	1,612	1,515	1,243
Encyclopedias, other reference materials	746	770	836
Home cleaning systems	2,575	2,627	2,647
Uniform manufacturing and distribution	1,698	1,192	392
Other	13,421	13,960	14,446
	$ 27,002	$ 26,821	$ 25,964

Identifiable Assets At Year-End

	Dec. 31, 1988	Dec.31, 1987	Dec. 31 1986
Insurance	$5,421,195	$4,519,657	$3,533,669
Candy	64,304	64,742	68,856
Newspaper	50,755	54,326	58,735
Retailing of home furnishings	70,660	71,461	64,946
Encyclopedias, other reference materials	85,675	80,318	76,893
Home cleaning systems	45,675	46,191	46,777
Uniform manufacturing and distribution	73,009	61,595	60,504
Other	1,005,575	964,945	1,020,974
	$6,816,848	$5,863,235	$4,931,354

Revenues of the Insurance Segment

	1988	1987	1986
Premiums written	$ 484,709	$ 751,253	$1,009,430
Premiums earned:			
Primary or direct insurance	$ 292,309	$ 441,635	$ 463,117
Reinsurance assumed excluding structured settlements and portfolio reinsurance	229,323	372,763	344,385
Subtotal	521,632	814,398	807,502
Structured settlements and portfolio reinsurance	62,603	10,497	16,382
Total premiums earned	584,235	824,895	823,884
Investment income	231,907	152,995	107,495
	$ 816,142	$ 977,890	$ 931,379

Insurance Segment Operating Profit Before Taxes

	1988	1987	1986
Underwriting gain (loss):			
Primary or direct insurance operations	$ 17,466	$ (2,715)	$ 3,538
Reinsurance assumed excluding structured settlements and portfolio reinsurance	(14,472)	(27,745)	(49,355)
Subtotal	2,994	(30,460)	(45,817)
Structured settlements and portfolio reinsurance	(14,075)	(24,969)	(10,027)
Total underwriting (loss)	(11,081)	(55,429)	(55,844)
Net investment income	231,250	152,483	107,143
	$ 220,169	$ 97,054	$ 51,299

BERKSHIRE HATHAWAY INC.
Quarterly Data — Unaudited
(dollars in thousands except per share amounts)

Revenues in this table are restated on a consolidated basis and, accordingly, are restated from those as last reported for each quarter prior to the 4th quarter of 1988.

		Revenues	Earnings Before Realized Investment Gain	Realized Investment Gain	Net Earnings	Net Earnings Per Share
1st quarter	— 1988	$600,563	$77,835	$21,222	$ 99,057	$ 86.38
	1987	623,585	57,219	3,255	60,474	52.73
2nd quarter	— 1988	$538,022	$69,506	$24,939	$ 94,445	$ 82.37
	1987	578,402	45,880	360	46,240	40.31
3rd quarter	— 1988	$570,763	$75,961	$ 8,564	$ 84,525	$ 73.73
	1987	567,147	49,239	11,917	61,156	53.32
4th quarter	— 1988	$623,874	$90,139	$31,104	$121,243	$105.75
	1987	633,810	62,408	4,274	66,682	58.15

Revenues and earnings from marketing of World Book products are concentrated in the first quarter. See's Candy sales peak at Easter and more notably so in the fourth quarter when more than one-half of annual revenues for that business are normally recorded. Holiday advertising revenues also tend to increase fourth quarter earnings recorded for the Buffalo News. A non-seasonal factor that may influence Berkshire's interim consolidated financial statements is that estimation error, inherent to the process of determining liabilities for unpaid losses of insurance subsidiaries, can be relatively more significant to results of interim periods than to results for a full year. Variations in amount and timing of realized securities gains or losses cause significant variations in periodic net earnings.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders
Berkshire Hathaway Inc.

We have audited the accompanying consolidated balance sheets of Berkshire Hathaway Inc. and subsidiaries as of December 31, 1988 and 1987, and the related consolidated statements of earnings and cash flows for each of the three years in the period ended December 31, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Berkshire Hathaway Inc. and subsidiaries as of December 31, 1988 and 1987, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1988, in conformity with generally accepted accounting principles.

As discussed in Note 1, the consolidated financial statements give retroactive effect to the Company's adoption in 1988 of Statement of Financial Accounting Standards No. 94, "Consolidation of All Majority-Owned Subsidiaries."

TOUCHE ROSS & CO.

March 8, 1989
Omaha, Nebraska

BERKSHIRE HATHAWAY INC.
Management's Discussion and Analysis of
Financial Condition and Results of Operations

Results of Operations

Throughout this discussion, data with respect to years prior to 1988 have been restated if required to conform to consolidation and other reporting practices applied for 1988.

Net earnings for each of the past three years are disaggregated in the table that follows.

	Contribution to Net Earnings 000s Omitted		
Activity or Item	*1988*	*1987*	*1986*
Insurance	$196,734	$115,962	$ 66,576
Manufacturing, merchandising, and services	145,635	109,681	80,743
Interest on debt excluding finance companies' debt	(23,212)	(5,905)	(12,213)
Other unallocated corporate costs	(5,716)	(4,992)	(3,642)
Earnings before realized investment gain	313,441	214,746	131,464
Realized investment gain	85,829	19,806	150,897
Net earnings	$399,270	$234,552	$282,361

All of the above data is tax-effected and differs in that respect from pre-tax earnings data presented elsewhere in this report.

Insurance

The after-tax figures shown above for the Insurance segment derive from the following:

	000s Omitted		
	1988	*1987*	*1986*
Underwriting gain (loss):			
Primary or Direct Insurance Operations	$ 17,466	$ (2,715)	$ 3,538
Reinsurance Assumed, excluding Structured Settlements and Portfolio Reinsurance	(14,472)	(27,745)	(49,355)
Structured Settlements and Portfolio Reinsurance	(14,075)	(24,969)	(10,027)
Underwriting loss — pre-tax	(11,081)	(55,429)	(55,844)
Applicable income tax credit*	9,670	34,461	25,688
Applicable minority interest	366	309	292
After-tax underwriting loss	(1,045)	(20,659)	(29,864)
After-tax net investment income	197,779	136,621	96,440
Net earnings	$196,734	$115,962	$ 66,576

**Income tax credits applicable to underwriting losses include a "fresh start" tax benefit of approximately $5 million for 1988 and $8 million for 1987.*

The capsulized data in the table below provides greater perspective with respect to the Berkshire Hathaway Insurance Group's underwriting activities for the past several years. Amounts are stated in millions of dollars.

	Premiums		*Pre-tax Underwriting*	*Year-End*
Year	*Written*	*Earned*	*Loss*	*Float*
1984	$ 134	$140	$(48)	$ 264
1985	497	317	(44)	515
1986	1,009	824	(56)	1,078
1987	751	825	(55)	1,458
1988	485	584	(11)	1,540

Insurance (continued)

"Float" in the preceding table has been computed to include the sum of unpaid losses, unpaid loss adjustment expenses and unearned premiums, less agents balances receivable, amounts recoverable as reinsurance on paid losses, and deferred policy acquisition costs. The net result is a rough approximation of investable policyholder funds. The Berkshire Hathaway Insurance Group's book of business is unusually volatile in its makeup — both as to number and as to nature of covered risks. Recent significant changes in annual premium volume of the Group have resulted in relationships between the Group's float and premium volume that are inconsistent from period to period. The ratio has now risen to an unusually high level. It is expected to remain so for some time.

The succeeding discussions of underwriting results deal with specified subsegments of Berkshire's insurance business. The section "Primary or Direct Insurance Underwriting", immediately following, deals with those operations where insurance policies are issued to named insureds that are directly subject to the risks insured against. The term is used to distinguish such business from that of reinsurance assumed activities that involve insuring other insurers.

<u>Primary or Direct Insurance Underwriting</u>

A summary follows of the combined underwriting results, determined on the basis of generally accepted accounting principles ("GAAP"), of the Berkshire Hathaway Insurance Group's primary or direct insurance operations. Dollars are in thousands.

	1988		*1987*		*1986*	
	Amount	*%*	*Amount*	*%*	*Amount*	*%*
Premiums written	$218,838		$412,748		$594,607	
Premiums earned	292,309	100.0	441,635	100.0	463,117	100.0
Losses and loss expenses	196,165	67.1	338,575	76.7	347,468	75.0
Underwriting expenses	[illegible],678	26.9	105,775	23.9	112,111	24.2
Total losses and expenses	274,843	94.0	444,350	100.6	459,579	99.2
Underwriting gain (loss) — pre-tax	$ 17,466		$ (2,715)		$ 3,538	

The decline in the number of risks accepted in Berkshire's primary or direct insurance operations accelerated in 1988. During the year, industry price competition continued to increase and, accordingly, premium rates continued to decrease. Group members are expected by management to practice disciplined underwriting, a consequence of which is a decrease in accepted risks occurring in periods of decreasing prices. The decrease in total written premiums in this subsegment was 47% in 1988 from 1987, following a decrease of 30% in 1987 from 1986. Premiums earned, which lags premiums written, declined in 1988 by one-third from 1987. Principally because total payroll costs chargeable to underwriting expenses of the business declined only nominally in 1988, the ratio of underwriting expenses to premiums earned increased for 1988 as shown above.

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

	000s Omitted		
	1988	*1987*	*1986*
Unpaid losses and loss expenses at beginning of year	$628,077	$429,505	$209,236
Incurred losses recorded:			
Current year occurrences	225,309	348,010	331,463
All prior years' occurrences	(29,144)	(9,435)	16,005
	196,165	338,575	347,468
Payments with respect to:			
Current year occurrences	39,263	44,856	53,086
All prior years' occurrences	117,387	95,147	74,113
	156,650	140,003	127,199
Unpaid losses and loss expenses at end of year	$667,592	$628,077	$429,505

Management's Discussion *(continued)*
Insurance (continued)

The favorable loss development in 1988 of $29 million represents 10% of the year's earned premiums from the primary or direct business. That favorable development mostly derives from re-estimation of pre-1988 loss and loss expense liabilities, though in small part, it is attributable to actual settlements made at a lower cost than amounts previously reserved. The amount of favorable development has little predictive value with respect to how much additional development will reveal itself, nor whether such development will be favorable or unfavorable. About $14 million of the 1988 favorable development relates to changed estimates for loss costs with respect to principally 1987 loss occurrences in National Indemnity Company's traditional auto bodily injury liability coverages for bus and truck operators. About $8.5 million of the development credit resulted from reduction of the liability provision for prior years' loss occurrences covered under excess-of-loss, claims-made type policies.

Reinsurance Assumed, excluding Structured Settlements and Portfolio Reinsurance

The combined underwriting results, determined on a GAAP basis, with respect to the reinsurance assumed business, other than structured settlements and portfolio reinsurance, are summarized in the following table, with dollars in thousands.

	1988		1987		1986	
	Amount	%	Amount	%	Amount	%
Premiums written	$203,268		$328,011		$398,446	
Premiums earned	229,323	100.0	372,763	100.0	344,385	100.0
Losses and loss expenses	170,492	74.3	287,638	77.2	282,563	82.0
Underwriting expenses	73,303	32.0	112,870	30.2	111,177	32.3
Total losses and expenses	243,795	106.3	400,508	107.4	393,740	114.3
Underwriting (loss) — pre-tax	$(14,472)		$(27,745)		$(49,355)	

1988 activity of this subsegment is preponderantly representative of the major quota share reinsurance contract with Fireman's Fund.

Loss and loss expense data with respect to this reinsurance business is summarized below for the past three years.

	000s Omitted		
	1988	1987	1986
Unpaid losses and loss expenses at beginning of year	$488,098	$319,989	$114,191
Incurred losses recorded:			
Current year occurrences	169,688	283,151	261,554
All prior years' occurrences	804	4,487	21,009
	170,492	287,638	282,563
Payments with respect to:			
Current year occurrences	35,474	45,201	43,711
All prior years' occurrences	91,782	74,328	33,054
	127,256	119,529	76,765
Unpaid losses and loss expenses at end of year	$531,334	$488,098	$319,989

Insurance (continued)

Structured Settlements and Portfolio Reinsurance

Analyses of loss developments for the Structured Settlements and Portfolio Reinsurance business are not meaningful because, at inception of these contracts, it is predictable that subsequent underwriting losses will result in varying amounts that are reasonably estimable. Acceptance of the business nevertheless occurs after appraisal on a proposal-by-proposal basis of the value of funds expected to be generated thereby.

Insurance Segment Investment Income

	000s Omitted			
	Investment Income Before Taxes	*Applicable Income Taxes*	*Applicable Minority Interest*	*Investment Income After Taxes and Minority Int.*
1988	$231,250	$30,698	$2,773	$197,779
1987	152,483	13,670	2,192	136,621
1986	107,143	9,094	1,609	96,440

The increased "float", detailed earlier, combined with reinvested earnings plus contributions made by Berkshire to capital of the Group in the three years, have resulted in significantly increased levels of investment, and, accordingly, significantly increased amounts of investment income as reflected above.

Manufacturing, Merchandising and Services

Results of operations for the past three years of Berkshire's diverse non-insurance businesses are summarized in the following table, in thousands of dollars:

	1988		*1987*		*1986*	
	Amount	*%*	*Amount*	*%*	*Amount*	*%*
Revenues	$1,517,080	100.0	$1,425,054	100.0	$1,300,065	100.0
Costs and expenses	1,274,466	84.0	1,220,643	85.7	1,122,763	86.4
Earnings before income taxes	242,614	16.0	204,411	14.3	177,302	13.6
Applicable income taxes	90,604	6.0	90,114	6.3	92,329	7.1
Applicable minority interest	6,375	0.4	4,616	0.3	4,230	0.3
Net earnings	$ 145,635	9.6	$ 109,681	7.7	$ 80,743	6.2

Combined revenues of the diverse group of non-insurance businesses increased approximately 6% from 1987 to 1988, following an increase of approximately 9% from 1986 to 1987. Pre-tax profits also increased in each of the two most recent years over those of the immediately preceding year. Revenue and pre-tax profits for 1988 include approximately $16.4 million of asset reversions from terminated pension plans. Otherwise, dollar increases in pre-tax earnings, like the dollar increase in revenues, were shared among virtually every constituent operation in both 1988 and 1987.

Aggregate after tax earnings of the Group were further improved over the immediately prior year, both for 1988 and for 1987, by lower rates of applicable Federal income taxes. The decreased rates reflect provisions of the 1986 Tax Reform Act. The statutory Federal corporate rate was 46% for 1986, 40% for 1987 and 34% for 1988.

Interest Expense

Interest on debt increased in 1988, reflecting increased outstanding borrowings, principally Berkshire's $250 million face amount of debentures due 2018, issued in January 1988. Interest expense in 1987 was less than in 1986 because Berkshire's $60 million outstanding issue of 12¾% debentures was called for early redemption in December 1986.

Management's Discussion *(continued)*

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, 1988 reflects continuing capital strength. Berkshire shareholders' equity has increased from approximately $1.9 billion at December 31, 1985 to approximately $3.4 billion at December 31, 1988. In that three-year period, realized and unrealized securities gains increased equity capital by approximately $860 million. Reinvested earnings, other than realized securities gains, were approximately $660 million for the three years.

In January, 1988 Berkshire issued $250,000,000 face amount of 30 year debentures, redeemable through sinking funds commencing in 1999. Proceeds from the issue were contributed to the equity capital of the Insurance Group. The obligations bear interest at approximately 10% per annum and final maturity is in January, 2018. Berkshire borrowed the funds not with a view to any immediate cash needs but rather to increase its already substantial liquidity. Somewhat improved ability to respond to future business acquisition opportunities was the result.

Shortly after 1988 year-end, Standard & Poors Corporation announced an upgrade to AAA in the credit rating it has assigned to Berkshire debt.

* * *

BERKSHIRE HATHAWAY INC.

INSURANCE GROUP

Berkshire's insurance business is conducted by 12 separate subsidiaries, headed by National Indemnity Company, headquartered in Omaha, Nebraska. The members underwrite multiple lines of principally casualty coverages for primarily commercial accounts, providing, for example, liability coverages for truck and bus operators, and casualty coverages for especially large or unusual risks. Members domiciled in the states of Colorado, Kansas and Nebraska provide standard multiple-line property/casualty insurance to "homestate" residents. A California domiciled member provides workers' compensation insurance in that state. Through a four-year quota share reinsurance contract effective September 1, 1985, the Group has participated to the extent of 7% in all of the property/casualty insurance business underwritten by Fireman's Fund Insurance Companies, nationally known insurers that offer their insurance products nationally.

The Berkshire Hathaway Insurance Group maintains capital strength at unparalleled high levels, significantly higher than normal in the industry. This strength differentiates Group members from their competitors. For example, the Group's net premiums written in 1988 were approximately 14% of the Group's year-end statutory surplus. That compares to an industry average premiums-to-surplus ratio of about 190%. The obvious margins of safety thus provided to insureds of the Group are particularly persuasive in marketing of individually negotiated financial insurance and reinsurance contracts, including liability assumptions with respect to loss portfolios and with respect to periodic payment contracts (structured settlements).

Combined financial statements of the Berkshire Hathaway Inc. Insurance Group are presented on the following two pages.

BERKSHIRE HATHAWAY INC.

INSURANCE GROUP

Balance Sheets
(dollars in thousands)

	December 31, 1988	December 31, 1987
Assets		
Investments:		
Fixed maturities at amortized cost:		
Bonds:		
Wash. Pub. Power Supply System	$ 246,982	$ 235,682
Other	802,916	1,004,755
Redeemable preferred stocks:		
Salomon Inc.	624,000	624,000
Other	10,548	15,689
Equity Securities at market:		
Common stocks:		
Capital Cities/ABC, Inc.	1,068,637	1,017,750
Coca-Cola Company	632,448	—
GEICO	849,400	756,925
Washington Post	364,126	323,092
Other	498,614	215,107
Nonredeemable preferred stocks	8,606	4,430
	5,106,277	4,197,430
Cash and cash equivalents	121,614	109,134
Receivables	139,702	131,230
Deferred insurance premium acquisition costs	45,456	57,239
Other	3,299	24,624
	$5,416,348	$4,519,657
Liabilities		
Loss and loss adjustment expenses	$1,407,189	$1,260,422
Unearned premiums	241,818	341,344
Accounts payable, accruals and other	85,387	55,717
Income taxes (Deferred: $547,635, 1988; $467,190, 1987)	565,310	471,939
	2,299,704	2,129,422
Equity		
Minority shareholders'	24,957	21,152
Berkshire shareholders'	3,091,687	2,369,083
	3,116,644	2,390,235
	$5,416,348	$4,519,657

These statements are unaudited.

BERKSHIRE HATHAWAY INC.

INSURANCE GROUP

Statements of Earnings
(dollars in thousands)

	1988	1987	1986
Premiums written	$ 484,709	$ 751,253	$1,009,430
Premiums earned	$ 584,235	$ 824,895	$ 823,884
Losses and loss expenses	437,695	661,146	655,758
Underwriting expenses	157,621	219,178	223,970
Total losses and expenses	595,316	880,324	879,728
Underwriting loss — pre-tax	(11,081)	(55,429)	(55,844)
Net investment income	231,250	152,483	107,143
Earnings from operations before income taxes	220,169	97,054	51,299
Income taxes — credit (expense)	(21,029)	20,790	16,594
	199,140	117,844	67,893
Minority interest	2,406	1,882	1,317
Earnings before realized investment gain	196,734	115,962	66,576
Realized investment gain, net	83,946	18,729	147,499
Net earnings	$ 280,680	$ 134,691	$ 214,075

Statements of Net Investment Income
(dollars in thousands)

	1988	1987	1986
Interest:			
Substantially exempt from Federal income taxes:			
Wash. Pub. Power Supply System	$ 34,615	$ 32,293	$ 30,533
Other	64,545	68,310	40,431
Taxable	46,701	21,177	19,025
	145,861	121,780	89,989
Dividends:			
Capital Cities/ABC, Inc.	590	590	590
Coca-Cola Company	4,393	—	—
GEICO	11,234	9,316	7,398
Salomon Inc.	56,160	14,040	—
Washington Post	2,695	2,212	1,935
Other	10,974	5,057	7,584
	231,907	152,995	107,496
Investment expenses	(657)	(512)	(353)
Net investment income	$ 231,250	$ 152,483	$ 107,143

These statements are unaudited.

BERKSHIRE HATHAWAY INC.

MANUFACTURING, PUBLISHING AND RETAILING BUSINESSES

Combined financial statements of Berkshire's Manufacturing, Publishing and Retailing businesses are presented on the following page. The operations whose data have been combined in these presentations include Berkshire's six non-insurance "reportable business segments," as well as the following:

Operation	*Activity/product/service*
Adalet	Conduit fittings, explosion proof fittings, junction boxes
Blue Chip Stamps	Trading stamps
Campbell Hausfeld	Air compressors, airless paint sprayers
Carefree	Roll-up awnings, other RV accessories
France	Appliance timing controls, ignition transformers
Halex	Zinc and aluminum die cast fittings
K&W Products	Automotive compounds
Meriam	Pressure and flow measurement devices
Northland	Fractional horsepower motors
Powerwinch	Boat winches, windlasses
Precision	Steel service center
Quikut	Varieties of cutlery
Scot Labs	Maintenance chemicals
Stahl	Custom steel bodies for truck chassis
Wayne Home Equipment	Furnace burners; sump, utility & sewage pumps
Western Enterprises	Gas transmission line fittings
Western Plastics	Molded plastic parts

The six non-insurance "reportable business segments" are more fully described below.

Newspaper — *The Buffalo News*, a division of Berkshire, publishes a Sunday edition and seven editions each weekday. It is the only metropolitan newspaper published daily within a ten county upstate New York distribution area that comprises one of the nation's 50 largest primary market areas.

Uniform Manufacturing and Distribution — Berkshire acquired its 85% ownership interest of *Fechheimers* in mid-1986. Fechheimers manufactures its products at plants in Kentucky, Ohio, Tennessee and Texas, for marketing through approximately three dozen company-owned retail distribution centers and by independent dealers who together serve more than 200 of the country's major metropolitan areas.

Home Cleaning Systems — This segment of Berkshire's business is principally represented by *Kirby* cleaning systems and products, sold to approximately 600 factory distributors who in turn sell them to a network of area distributors and dealers. Independent dealers employ in-the-home demonstrations for direct resale to consumers. *Douglas Products Company* manufacturers specialty vacuum cleaners such as hand-held electric and cordless units distributed through department stores, catalogue showrooms and hardware stores. Data with respect to *Cleveland Wood Products Company*, a manufacturer of vacuum cleaner brushes, is also reported within this segment.

Retailing of Home Furnishings — *The Nebraska Furniture Mart* operates a home furnishing retail business from a very large — over 200,000 square feet — retail outlet and sizable warehouse facilities in Omaha, Nebraska. It serves a trade area with a radius around Omaha of approximately 300 miles. Berkshire owns 80% of this business; key managers own 20%.

Candy — *See's* produces boxed chocolates and other confectionary products with an emphasis on quality in two large kitchens in California. See's distributes its candies through its own retail stores — over 200 in number — located in 12 western and midwestern states, including Hawaii. A meaningful volume of candy business is also recorded for direct shipments made nationwide from a seasonally-varying number of quantity order distribution centers.

Encyclopedias, Other Reference Materials — *World Book* encyclopedias as well as *Childcraft* and *Early World of Learning*, a preschool educational program, are among the products of this segment. Revised editions of the encyclopedia are composed and published annually. In the first quarter of each year an updating yearbook is published and marketed by mail to owners of earlier editions. Otherwise, products are marketed primarily by the direct sales method to schools, libraries and individual households by a commissioned sales force of thousands located throughout the United States, Canada, Australia and the British Isles.

BERKSHIRE HATHAWAY INC.

MANUFACTURING, PUBLISHING and RETAILING BUSINESSES

Balance Sheets
(dollars in thousands)

	December 31, 1988	December 31, 1987
Assets		
Cash and cash equivalents	$ 43,376	$ 36,201
Accounts receivable	150,394	141,986
Inventories	133,762	122,484
Properties and equipment	130,363	130,591
Other	15,670	21,953
	$ 473,565	$ 453,215
Liabilities		
Accounts payable, accruals and other	$ 179,301	$ 193,614
Income taxes	47,738	52,324
Term debt and other borrowings	37,704	38,750
	264,743	284,688
Equity		
Minority shareholders'	18,999	14,457
Berkshire shareholders'	189,823	154,070
	208,822	168,527
	$ 473,565	$ 453,215

Statements of Earnings
(dollars in thousands)

	1988	1987	1986
Revenues:			
Sales and service revenues	$1,407,642	$1,326,829	$1,219,252
Interest income	6,724	6,789	7,949
Sundry income	2,472	722	818
	1,416,838	1,334,340	1,228,019
Costs and expenses:			
Costs of products and services sold	747,831	699,730	641,884
Selling, general and administrative	461,783	445,970	413,095
Interest on debt	4,955	6,730	6,073
	1,214,569	1,152,430	1,061,052
Earnings from operations before income taxes	202,269	181,910	166,967
Income tax expense	76,216	79,588	83,184
	126,053	102,322	83,783
Minority interest	4,353	3,483	3,029
Net earnings	$ 121,700	$ 98,839	$ 80,754

Purchase price accounting adjustments, including goodwill, arising from Berkshire's business acquisitions are not reflected in these statements, but instead are reflected in the statements of non-operating activities at page 47.

These statements are unaudited.

BERKSHIRE HATHAWAY INC.

FINANCE-TYPE BUSINESSES

The consolidated financial statements of *Mutual Savings and Loan Association* and its subsidiary and of *Scott Fetzer Financial Group, Inc.* and its subsidiaries have been combined in the financial statements presented on this and the following page for Berkshire's finance-type operations. Berkshire's purchase price accounting adjustments relating to negative goodwill attributable to Mutual are not reflected in these statements, but instead are reflected in the statement of non-operating activities at page 47.

Balance Sheets
(dollars in thousands)

	December 31, 1988	December 31, 1987
Assets		
Cash and cash equivalents	$ 63,193	$ 77,029
Investments at cost:		
Fixed maturities:		
Bonds	48,013	103,425
Redeemable preferred stocks	30,524	27,506
Equity securities:		
FHLMC preferred stock	71,729	6,422
Other nonredeemable preferred stocks	36,852	27,257
Collateralized loans receivable (1)	136,970	139,438
Installment and other receivables	152,807	164,656
Prepaid income taxes	13,558	3,011
Other	14,375	9,332
	$ 568,021	$ 558,076
Liabilities		
Savings accounts	$ 288,522	$ 287,126
Accounts payable, accruals and other	32,759	12,673
Income taxes	1,807	2,834
Term debt and other borrowings	150,202	157,721
	473,290	460,354
Equity		
Minority shareholders'	9,882	11,255
Berkshire shareholders'	84,849	86,467
	94,731	97,722
	$ 568,021	$ 558,076

Statements of Earnings
(dollars in thousands)

	1988	1987	1986
Revenues:			
Interest and fees on loans and financed receivables	$ 50,230	$ 47,858	$ 40,799
Interest and dividends on investment securities	20,842	22,708	19,607
Sundry income	287	255	495
	71,359	70,821	60,901
Expenses:			
Interest on savings accounts	20,840	20,944	22,396
Interest on debt	14,088	15,060	9,235
General and administrative	23,313	29,493(2)	20,513
	58,241	65,497	52,144
Earnings from operations before income taxes	13,118	5,324	8,757
Income tax credit (expense)	(1,867)	138	(1,235)
	11,251	5,462	7,522
Minority interest	934	191	430
Earnings before realized investment gain	10,317	5,271	7,092
Realized investment gain, net	166	670	2,022
Net earnings	$ 10,483	$ 5,941	$ 9,114

(1) Includes mortgage-backed securities of $45,367, 1988 and $52,080, 1987.
(2) Includes $3,618 write off of prepaid FSLIC insurance premiums.

These statements are unaudited.

BERKSHIRE HATHAWAY INC.

NON-OPERATING ACTIVITIES

These statements reflect the consolidated financial statement values for assets liabilities, shareholders' equity, revenues and expenses that were not assigned to any Berkshire operating group in the unaudited group financial statements heretofore presented (pages 41 to 46).

Statements of Net Assets
(dollars in thousands)

	December 31, 1988	December 31, 1987
Assets		
Cash and cash equivalents	$ 38,511	$ 10,513
Investments:		
Fixed maturities		
Bonds	2,338	10,588
Salomon Inc redeemable preferred stock	50,000	50,000
Common stocks	28,312	11,462
Property account adjustments (1)	83,348	89,690
Unamortized goodwill (1)	117,970	120,655
Prepaid income taxes	9,983	20,402
Other	53,606	43,413
	$ 384,068	$ 356,723
Liabilities		
Accounts payable, accruals and other	$ 28,067	$ 18,192
Income taxes	7,591	2,815
Term debt and other borrowings	292,103	93,415
	327,761	114,422
Equity		
Minority shareholders'	12,558	10,262
Berkshire shareholders'	43,749	232,039
	56,307	242,301
	$ 384,068	$ 356,723

Statements of Earnings
(dollars in thousands)

	1988	1987	1986
Revenues:			
Interest and dividend income	$ 7,404	$ 6,969	$ 6,141
Sundry income	25,062(2)	13,826	5,481
	32,466	20,795	11,622
Expenses:			
Corporate administration	3,754	3,380	2,748
Shareholder designated contributions	4,966	4,938	3,997
Amortization of goodwill (1)	2,719	2,862	2,555
Property account adjustments (1)	6,937	5,546	10,033
Interest on debt	30,658	4,930	18,454(3)
Other costs and expenses	538	1,754	2,894
	49,572	23,410	40,681
Excess of expenses before income taxes	(17,106)	(2,615)	(29,059)
Income tax credit (expense)	2,513	(2,111)	6,525
	(14,593)	(4,726)	(22,534)
Minority interest	717	600	424
Loss before credit for realized investment gain	(15,310)	(5,326)	(22,958)
Realized investment gain, net	1,717	407	1,376
Net loss	$ (13,593)	$ (4,919)	$ (21,582)

(1) "Property account adjustments" and goodwill arose in accounting for business acquisitions.
(2) Includes asset reversions of $16,366 arising from the termination of defined benefit pension plans.
(3) Includes pre-payment penalty of $5,355 relating to called 12¾% debentures.

These statements are unaudited.

BERKSHIRE HATHAWAY INC.

SHAREHOLDER-DESIGNATED CONTRIBUTIONS

The Company has conducted this program of corporate giving during each of the past eight 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 . . .

"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
1987	$5	97.2%	4,937,574	2,050
1988	$5	97.4%	4,965,665	2,319

**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.

* * *

The program may not be conducted in the occasional year, if any, when contributions by Berkshire would produce substandard or no tax deductions. In other years Berkshire expects to inform shareholders about October 10th of the amount per share that may be designated. A reply form will accompany the notice, allowing shareholders about six weeks — or until about November 30 — to respond with their designations. *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, shares must be registered in the owner's individual name(s) or the name of an owning trust, corporation, partnership or estate, as applicable, on Berkshire's shareholder list of September 30th, or the Friday preceding if such date falls on a Saturday or Sunday.

Before the November, 1988 listing for trading on the New York Stock Exchange of the common shares of Berkshire Hathaway Inc., the Chairman sent to the shareholders the letter reproduced on this and the following page, giving background and rationale for the Company's application for the listing.

August 5, 1988

To the Shareholders of Berkshire Hathaway Inc.:

It is likely that in a few months Berkshire shares will be traded on the New York Stock Exchange. Our move there would be made possible by a new listing rule that the Exchange's Board of Governors has passed and asked the SEC to approve. If that approval is forthcoming, we expect to apply for a listing, which we believe will be granted.

Up to now, the Exchange has required newly-listed companies to have a minimum of 2,000 shareholders who each own 100 shares or more. The purpose of this rule is to insure that NYSE-listed companies enjoy the broad investor interest that facilitates an orderly market. The 100-share standard corresponds to the trading unit ("round lot") for all common stocks now listed on the Exchange.

Because Berkshire has relatively few shares outstanding (1,146,642), it does not have the number of 100-share-or-more holders that the Exchange has required. A ten-share holding of Berkshire, however, represents a significant investment commitment. In fact, ten Berkshire shares have a value greater than that of 100 shares of any NYSE-listed stock. The Exchange, therefore, is willing to have Berkshire shares trade in ten-share "round lots."

The Exchange's proposed rule simply changes the 2,000 shareholder minimum from one measured by holders of 100 shares or more to one measured by holders of a round lot or more. Berkshire can easily meet this amended test.

Charlie Munger, Berkshire's Vice Chairman, and I are delighted at the prospect of listing, since we believe this move will benefit our shareholders. We have two criteria by which we judge what marketplace would be best for Berkshire stock. First, we hope for the stock to consistently trade at a price rationally related to its intrinsic business value. If it does, the investment result achieved by each shareholder will approximate Berkshire's business result during his period of ownership.

Such an outcome is far from automatic. Many stocks swing between levels of severe undervaluation and overvaluation. When this happens, owners are rewarded or penalized in a manner wildly at variance with how the business has performed during their period of ownership. We want to avoid such capricious results. Our goal is to have our shareholder-partners profit from the achievements of the business rather than from the foolish behavior of their co-owners.

Consistently rational prices are produced by rational owners, both current and prospective. All of our policies and communications are designed to attract the business-oriented long-term owner and to filter out possible buyers whose focus is short-term and market-oriented. To date we have been successful in this attempt, and Berkshire shares have consistently sold in an unusually narrow range around intrinsic business value. We do not believe that a NYSE listing will improve or diminish Berkshire's prospects for consistently selling at an appropriate price; the quality of our shareholders will produce a good result whatever the marketplace.

But we do believe that the listing will reduce transaction costs for Berkshire's shareholders — and that is important. Though we want to attract shareholders who will stay around for a long time, we also want to minimize the costs incurred by shareholders when they enter or exit. In the long run, the aggregate pre-tax rewards to our owners will equal the business gains achieved by the company less the transaction costs imposed by the marketplace — that is, commissions charged by brokers plus the net realized spreads of market-makers. Overall, we believe these transaction costs will be reduced materially by a NYSE listing.

As we pointed out in the 1984 Annual Report, transaction costs are very heavy for active stocks, often amounting to 10% or more of the earnings of a public company. In effect, these costs act as a hefty tax on owners, albeit one based on individual decisions to "change chairs" and one that is paid to the financial community rather than to Washington. Our policies and your investment attitude have reduced this "tax" on Berkshire owners to what we believe is the lowest level among large public companies. A NYSE listing should further reduce this cost for Berkshire's owners by narrowing the market-maker's spread.

Under NYSE rules we must have at least two independent directors. Among the Board of Directors you elected in May, only Malcolm Chace, Jr. meets their test of independence.

But from this deficiency comes a good result. Charlie and I are pleased to inform you that Walter Scott, Jr., CEO of Peter Kiewit Sons', Inc. has joined the Berkshire board. PKS is one of the remarkable business stories of our time. The company, which is employee-owned, has a long-term financial record so good that I'm not going to recite it for fear of stirring unrest among our shareholders. Throughout his lifetime, Pete Kiewit ran the company as a strict meritocracy and it was in this tradition that he picked Walter to succeed him upon his death. Walter instinctively thinks like an owner and he will feel at home on the Berkshire board.

One final comment: *You should clearly understand that we are not seeking a NYSE listing for the purpose of achieving a higher valuation on Berkshire shares. Berkshire should sell, and we hope will sell, on the NYSE at prices similar to those it would have commanded in the over-the-counter market, given similar economic circumstances.* The NYSE listing should not induce you to buy or sell; it simply should cut your costs somewhat should you decide to do either.

Warren E. Buffett

Chairman of the Board

The 1988 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 1988 increased to $23,564,000 ($3.31 per share) from $16,612,000 ($2.33 per share) in the previous year.

Consolidated net income (i.e., after unusual operating losses and all net gains from sales of securities) increased to $30,089,000 ($4.22 per share) from $15,213,000 ($2.14 per share) in the previous year.

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 principally 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, 1988		December 31, 1987	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income (loss) of:				
Mutual Savings	$ 4,694	$ .66	$ 2,895	$ .41
Wesco-Financial Insurance business	12,094	1.70	9,459	1.33
Precision Steel's businesses	3,167	.44	2,450	.34
All other "normal" net operating income(2)	3,609	.51	1,808	.25
	23,564	3.31	16,612	2.33
Gain on sale of interest in Bowery Savings Bank	4,836	.68	—	—
Net gains on sales of marketable securities	1,689	.23	1,208	.17
Writeoff by Mutual Savings of prepaid FSLIC insurance premiums(3)	—	—	(1,935)	(.27)
Flood loss at Precision Steel	—	—	(672)	(.09)
Wesco consolidated net income	$30,089	$4.22	$15,213	$2.14

(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) Necessitated by the Federal Home Loan Bank's elimination of the savings and loan industry's nearly $1-billion secondary insurance reserve, consisting of deposit insurance premiums prepaid to FSLIC, the U.S. agency which insures accounts in savings and loan associations.

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.

Mutual Savings

Mutual Savings' "normal" net operating income of $4,694,000 in 1988 represented an increase of 62% from the $2,895,000 figure the previous year.

The high percentage increase in 1988 was partly fluke. The interest rate curve happened to be precisely adapted to Mutual Savings' needs during most of the year, and already, in 1989, net interest margins are impaired as short-term rates and intermediate-term rates have become more or less identical.

Moreover, these "normal-income" figures come from a decidedly abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1987 and 1988 are set forth at the end of this annual report. They show (1) total savings accounts rising to $289 million from $287 million the year before, (2) a very high ratio of shareholders' equity to savings account liabilities (near 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, and (4) a loan portfolio (mostly real estate mortgages) of about $137 million at the end of 1988, down slightly from $139 million at the end of 1987.

The loan portfolio at the end of 1988, although containing almost no risk of loss from defaults, bore an average interest rate of only 8.70%, probably near the lowest among U.S. savings and loan associations, but up moderately from 8.38% at the end of 1987. Because the loan portfolio is almost entirely made up of instruments of short maturity or bearing interest rates that adjust automatically with the market, there is now less unrealized depreciation in the loan portfolio than the net unrealized appreciation in Mutual Savings' interest-bearing securities and public utility preferred stocks. That appreciation at December 31, 1988 was about $7.5 million.

While the "spread" between Mutual Savings' average interest rates paid on savings and received on loans remains too low to provide respectable profits, this "spread" improved last year. Moreover, the disadvantage from inadequate "spread" has been reduced in each recent year by the effect of various forms of tax-advantaged investment, primarily preferred stock and municipal bonds. The negative side of this tax-advantaged antidote to inadequate interest rate margin on loans is the risk that preferred stock and municipal bonds, with their fixed yield and long life, will decline in value and not provide enough income to cover Mutual Savings' interest costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment is kept conservative, relative to the amount of its net worth.

Mutual Savings remains a "qualified thrift lender" under the federal regulatory definition requiring 60% of assets in various housing-related categories. It plans to continue keeping substantially all loans receivable either with short expected lives or with interest rates that fluctuate with the market. All new variable-rate loans are "capped" at the 25% per annum level, which is over ten percentage points higher than the normal 2½-points-over-market "cap" offered by competing associations. Naturally, to gain this extra protection from interest rate increase, Mutual Savings "pays" by (1) getting lower "spreads" over an interest rate index, and (2) not being able to make loans in amounts desired.

As pointed out in Note 10 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings ($49.7 million at December 31, 1988) 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 for the $49.7 million reported as book value, the parent corporation would receive much less than $49.7 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.

Mutual Savings has not only a buried value in unrealized appreciation of securities but also a buried value in real estate. The foreclosed property on hand (mostly 22 acres at or near the oceanfront in Santa Barbara) has become worth over a long holding period considerably more than its $5.4 million balance sheet carrying cost. Reasonable, community-sensitive development of this property has been delayed over 13 years in the course of administration of land-use laws. But, miraculous to report, grading, street and public utilities work is now nearly finished, and significant other construction work is now under way on the property for an authorized 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 value in real estate is limited by the small number of houses allowed (32) and by the fact that only about half of such houses will have a significant ocean view. Additional limitation will come from prospective high cost of private streets, sewage and utility improvements and connections, landscaping, and non-standardized, environmentally sensitive adaptation of housing to the site. Also, various charges and burdens, including heavy archaeological obligations 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 the present era. We have "given" a very large fraction of the value of our land to the County of Santa Barbara in exchange for permission to use it at all. In California these days such results are common, particularly in coastal areas.

The savings and loan association described in the foregoing paragraphs, quite different from most other associations for a long time, added a significant new abnormality during 1988. Mutual Savings increased its position in preferred stock of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 when-issued shares. This is 4% of the total shares outstanding, the legal limit for any one holder. As this letter is written, all of these 2,400,000 shares have been issued and paid for. Mutual Savings' average cost is $29.89 per share, compared to a price of $50.50 per share in trading on the New York Stock Exchange at the end of 1988. Thus, based on 1988 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $49.5 million. At current tax rates the potential after-tax profit is about $29.2 million, or $4.10 per Wesco share outstanding.

Freddie Mac is a hybrid, run by a federal agency (the Federal Home Loan Bank Board), but now owned privately, largely by institutional investors. Freddie Mac supports housing primarily by purchasing housing mortgage loans for immediate transmutation into mortgage-backed securities that it guarantees and promptly sells. In the process Freddie Mac earns fees and "spreads" while avoiding most interest-rate-change risk. This is a much better business than that carried on by most (or indeed most of the top 10% of) savings and loan associations, as demonstrated by Freddie Mac's remarkable percentage returns earned on equity capital in recent years.

At Freddie Mac's current dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield is only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield is only 4.4%. But Freddie Mac has a very creditable history of raising its earnings and dividend rate, thus contributing to increases in the market price of its stock. The market price increases because Freddie Mac's "preferred" stock in substance is equivalent to common stock. Here are figures for 1985-1989:

Year Ended 12/31:	Earnings per Share	Dividends per Share	Year-End Market Price per Share	Freddie Mac's Return Earned on all Average Equity
1985	$2.98	$ .53	$ 9.19	30.0%
1986	3.72	1.13	15.17	28.5
1987	4.53	1.10	12.13	28.2
1988	5.73	1.25	50.50	27.5
1989 (announced)	?	1.60	?	?

The above numbers are unusually good for a stock selling at only $50.50 per share at the end of 1988. We think the probable cause of substandard investor response is some combination of (1) lack of familiarity with Freddie Mac among investors and (2) fear that the federal officials who control Freddie Mac will mismanage it or not deal fairly with Freddie Mac's private owners, perhaps under pressure from Congress.

There is, of course, some risk that Freddie Mac will ruin its remarkable business by ignoring fiduciary duties to new private owners, or reducing credit standards, or making bets on the future course of interest rates. But we consider such outcomes unlikely. The tendency to consider them likely rests largely in those who think ill of federal officials because of the dramatic, multi-billion-dollar insolvency of FSLIC (the U.S. agency which insures depositor accounts in savings and loan associations). This reaction is natural as it becomes ever more clear that the final FSLIC insolvency was agumented by regulatory failure to intervene early to solve easily diagnosed problems which were getting worse at a rapid rate.

But FSLIC and Freddie Mac are two separate entities, and the circumstances affecting the business of each are radically different. As the world changed, the troubles of FSLIC had roughly the following history and causes:

(1) In its early decades, the savings and loan industry lived under a system ordained by legislation in the 1930s. Interest rates paid by both banks and

associations were fixed by law at low levels, but with (i) a deposit-attracting advantage of ¼% more per annum which could be paid by associations and (ii) tax advantages for associations, compared with banks. The interest rate controls were created to dampen competition in an effort to prevent recurrence of the widespread failure of deposit-taking institutions which had followed the aggressive banking practices of the 1920s. In return for the cartel-like advantages granted and federal deposit insurance, associations were required to concentrate assets in home lending and to be conservative in risking losses from nonrepayment of loans. The standard practice of associations was then to borrow short (by taking demand deposits) and to lend long (by making long-term mortgage loans at fixed rates). Associations lived on an approximate two-percentage-point "spread" between the mortgage interest rate and the mandated low interest rate on deposits.

(2) This system always had a built-in risk that interest rates would generally and sharply rise, in which case the government would be forced to raise interest rates on deposits in order to enable associations to hold deposits. Then associations would be squeezed into losses because they were hooked by contract to fixed interest rates on old mortgages. But associations accommodated this risk, during periods of low inflation and slowly rising, government-fixed interest rates on deposits, by continuously "growing their way" out of profit-margin trouble. Associations simply "averaged up" the rate of interest on the whole mortgage portfolio by making ever larger amounts of new mortgage loans at higher interest rates. The necessary continuous growth, despite mandated low interest rates for savers, was made possible, of course, by the ¼% per annum deposit-attracting rate advantage possessed by associations. The system contained much wise and constructive cynicism, akin to that of the country's founding fathers. The system's creators wanted associations not to cause losses to FSLIC, the federal deposit-insurer, while helping the citizenry by favoring housing. So, knowing like Ben Franklin that "it is hard for an empty sack to stand upright," the creators simply gave associations significant competitive and tax advantages that made it easy for executives to do well while doing right. Also, because the creators admired "cooperative," workers'-self-help models and, looking back at the excesses of the 1920s, feared losses from capitalistic ambition more than they feared inefficiency from a more socialized process, all federally-chartered and most state-chartered associations were "mutual" institutions. Such institutions are "owned" by depositors and are therefore not capable of making any shareholder rich. In the early decades, this system, relying on carrot as well as stick, was, like the FHA, one of the most successful systems in U.S. history. It did a world of good at a trifling cost.

(3) Naturally, the few state-chartered, shareholder-owned associations (including Mutual Savings, which was "mutual" in name only) in due course became more aggressive than their "mutual" brethren and used their government-mandated competitive advantage to make their shareholders rich. This process was aided by their emphasizing high-yielding tract-housing loans in the

faster-growing parts of the country during a long boom. And envy plus logic then caused many "conversions" of formerly "mutual" associations to shareholder ownership, which, featuring different incentives, increased managements' proclivity to endure risk in the hope of above-normal reward. The heavy-risk-taking attitude finally spread throughout a large percentage of the savings and loan industry, including formerly conservative "mutual" institutions that remained "mutual" institutions.

(4) But, eventually, the tendencies of government to escalate currency debasement and of interest rates to rise sharply with sharp inflation combined to reduce the prosperity of the savings and loan industry, now structured more to produce extra profit when much went well than to prevent loss when much went wrong. As interest rates rose, even associations holding only high-grade, long-term, fixed-rate mortgages suffered large losses. Most gamier associations became hopelessly insolvent.

(5) In this new high-interest-rate environment, it proved impossible for most associations to "grow their way" out of trouble. Suddenly, the former bank and association duopoly faced new competition from "money market funds" that paid higher interest and also provided check-writing privileges, as well as from U.S. Treasury obligations that were more conveniently available. Not only could deposits not be increased; they could not be kept from shrinking.

(6) To prevent continuation of deposit outflows, which then tended to cripple housing, legislators decontrolled interest rates on all savings accounts. Next, after an irrational delay, the legislators allowed housing lending at interest rates that fluctuated with the market, a wise practice long standard in England. Even so, many associations remained insolvent "basket cases," because interest rates that had ratcheted upward on liabilities were matched against fixed and outdated rates on assets. Less impaired but still solvent associations had difficulty maintaining adequate equity capital without the "edge" possessed by the industry in its early years.

(7) In this period of trouble it also seemed logical to Congress and state legislatures, responding to non-apposite use of "free-market" labels and requests from savings and loan operators, to try to relieve the financial pressure by "helping" associations make more money. The method used was revision of investment rules for associations so that they could attempt to widen "spreads" by engaging in much more risky and difficult-to-manage deployments of assets that promised high yields if everything worked right. Deposit insurance was retained.

(8) But the coexistence of deposit insurance, liberalized asset deployment rules, and uncontrolled rates of interest which could be paid to savers had terrible consequences. The new system (despite minor impediments from some new anti-growth rules) enabled almost any association, even if small and remote and run by a crook or fool, to expand fast and almost without limit. When any association could use the government's credit and also promise to pay as high an interest rate as was required to bring in any desired amount of savings, the only

remaining limitation on size was the requirement that a small percentage of savings be matched with net worth. This was not much of a problem for growth-minded associations. The government, accommodatingly, *reduced* the percentage of net worth required. And when, after this help, growth was so great that more net worth was required to meet the relaxed general standard, such net worth could easily be provided, on paper, for a long time during expansion. After all, it is child's play to make any bank or savings and loan association report high profits for a while, thereby rapidly augmenting reported net worth, by making loans (or other asset deployments) providing both (i) high initial interest or profit accruals and (ii) probable high ultimate but delayed losses caused by the risks assumed. There are always real estate operators willing to sign any sort of promise or make any sort of projection in exchange for cash. The real estate crowd is notoriously optimistic and also includes a significant fraction of people like those who caused Mark Twain to define a mine as "a hole in the ground owned by a liar." Also, good short-term results are often available, in modern times, from merely committing money to sound borrowers for a very long time at a fixed rate, thus substituting lethal risk from interest rate change for lethal risk imposed by bad credit quality. Using one or more of the short-term, high-profit-reporting strategies, many minor associations soon grew to gargantuan size, often paying stockbrokers (and other brokers) commissions to bring in the massive amounts of deposits desired. The practice of using brokers to gain deposits had a high correlation with later insolvencies.

(9) The new system included a "runaway-feedback mode," exactly what every wise engineer or businessman learns to dread. It could and did entice into inappropriate conduct not only those always prone to bad behavior but also some associations that had formerly been admirable but were now suffering from bad luck. Once you were a loser and insolvent, for any reason, and very likely doomed, the system still granted you an opportunity to risk as much you wished of the government's money (your money was gone) in some massive gamble, on interest rates or business outcome, that had a chance of returning you to health. And, if the first gamble didn't work, you could always "double up." Such were the "parlay" possibilities for losers.

The losers' "parlays" were, quite predictably, made much quicker to arrange and much grander in scope by the availability of brokers who were paid to solicit government-insured deposits at above-normal interest rates (not a hard sale). The result was right out of *Alice in Wonderland*. For perhaps the first time in the history of regulation of deposit-taking institutions, the government (in the wry words of John Liscio of *Barron's*) was creating widespread "runs of money *into* small problem institutions and in the process turning them into big problem institutions."

For initial winners, shrewd or lucky in making risky investments, the "parlay" possibilities were immensely better. One instant-centimillionaire savings-and-loan family tried to gild the lily under such winning circumstances. The association involved proposed payment to a family executive of total compensation pushing $10 million per year. Then, after government regulators objected, the family satisfied itself with ordinary compensation (including bonus and special retirement contribution) of a mere $5 million or so. But the reduced ordinary compensation was supplemented by a lion's share of a huge new "incentive" to pay attention to business. Executives were granted rights to buy at attractive prices options or other securities of "junk bond" issuers which were available to the association at those attractive prices only in return for purchase of "junk bonds". ("Junk bonds" are bonds with high interest rates and grossly substandard credit backing that banks are pretty well forbidden to buy under their less permissive regulatory system. In recent years a large proportion of "junk bonds" were issued to help finance highly leveraged acquisitions and restructurings of corporations fearing or suffering from "raids" by hostile-takeover artists. Current practice is for deposit-insured banks to finance the most secured portion of massive corporate debt, which portion is maximized to a point which makes bank regulators sullen and fretful but not mutinous. Then some deposit-insured associations [and others] take loan positions so junior to many layers of senior debt [including but not limited to debt to banks] that language is strained when one calls them "loan positions." This anomaly in the total regulation of insured institutions is made possible [along with many other anomalies] by the division of total regulation into four systems [state and federal systems for both associations and banks] with some systems further subdivided to provide additional Balkanization.)

Such extraordinary success, in turn, had runaway-feedback possibilities of its own as examples of "parlayed" success became more widely known and envied, an enlightenment aided by brokers earning commissions or "spreads" by selling risky investments. In many cases, the end of the rapidly spreading winner's "parlay" game has not yet come. All we know is that the early phases look like many a speculative bubble which, in due course, was followed by a big bust.

There were other important consequences of the "parlay" games made possible by coexistence of decontrol and deposit insurance. The high interest rates promised by associations trying to "grow their way" out of trouble, or bent on instant-centimillionaire glory, tended to "bid up" the prices paid for savings by less ambitious associations in the would-be-conservative category. These institutions were therefore almost forced to consider high-rate, high-risk assets, so that they might have some chance of obtaining a moderate margin over costs. And thus was born the suggestion of a new sort of Gresham's law for deposit-insured, unlimited-interest-rate banking: "Bad lending drives out good."

The basic problem underlying this new form of Gresham's law may be impossible to solve, given the probable legislative premises that virtually unlimited deposit insurance, uncontrolled interest rates, wide discretion in deploying assets, and long grace periods when trouble comes, are each sacred. The problem is grounded deep in the nature of things, in the principle that in a complex system you can never "do merely one thing." When one variable is maximized other variables often get minimized in an undesired way. In this case, in making money ultra-easy for everyone to get and invest in any amount and way desired, thus maximizing the availability of investable money, Congress changed the savings and loan system in a way that made it harder for associations to reloan the money safely at interest rates that covered costs. Congress thus minimized the opportunities for earning profits safely. As Garrett Hardin, the biologist, (or perhaps George Stigler, the economist) might say: "How could it be otherwise?" At any rate, the result as we observe it seems to be, roughly, that every form of savings and loan operation that is safe and simple, so that ordinary executives can manage it, avoiding both all net interest-rate-change risk and all net credit risk, will provide no net profit. Therefore every association that wishes to continue to exist is forced either to be remarkably prescient or to endure some combination of net credit risk and net interest-rate-change risk. This, in turn, makes normal earnings at strong associations like those of an earthquake insurer in a year when there is no earthquake. (Remember, upward fluctuations in interest rates on modern home loans are typically "capped" a mere 2½ percentage points over the mortgage interest rate prevailing when the loans were made.) Also, weak associations, guided by the less able, less honest, or less lucky, after exhausting shareholders' equity, tend to cause big losses to the government agency which insures savings accounts. These losses may exceed resources provided by deposit-insurance premiums.

Indeed, a government agency that tries to depend on 100% of its thinly capitalized deposit-insurance patrons being of above-average ability in unrestricted asset management, unrestricted in scale, would be "bonkers" not to expect large insurance losses. The system we now have is not "free market" economics. It is non-economics.

[At this point it is logical to inquire: If the foregoing reasoning is correct, why doesn't it apply to banks and why is the FDIC, which insures bank deposits, now in so much better shape than FSLIC? We think the answers are (i) that the fundamental reasoning does apply to banks, and we note that irresponsible bank lending, bank losses and FDIC losses all escalated dramatically after the installation of unlimited interest rates in a banking system already containing deposit insurance, and (ii) that the FDIC losses are, so far, lower than FSLIC losses for reasons including the following:

(a) the profit-shortage pressure has been lower at banks because of favorable momentum effects from the past, particularly including the banks' long monopoly in checking accounts, difficulties faced by would-be new entrants into banking, and traditional bank avoidance, through continuous repricing of loans, of most risk from interest rate change; and

(b) there is much tougher regulation, including better domestic-asset-quality controls, under the bank regulatory apparatus.

The second factor is particularly important. Tougher regulation clearly limits damage to the deposit-insurer. Indeed, if the toughness of bank regulation could be doubled and redoubled, so that it closed banks summarily when liquidating value of equity was impaired but not exhausted, like the clearing system of a stock or commodity exchange, little would remain of expectancy of deposit-insurer loss from idiosyncratic high risk taking. It does not follow, however, that banks, even under such toughened regulation, would refrain from forms of high risk taking which became so conventional that trouble, if it came, would sink everyone at once. Under such circumstances, the regulated have a tendency to appraise regulatory threat as a paper tiger. Banking institutions (perhaps wisely) believe that the regulator which must close all banks will close none. Something like this has already occurred with respect to unwise foreign lending, where the regulatory response would, very likely, have been much tougher if only one big bank had been involved. Instead, with virtually all big banks threatened by huge holdings of dubious foreign loans, bank regulators are now much tougher on domestic loans worth 70¢ on the dollar than on foreign loans worth 40¢ on the dollar.]

(10) All of the foregoing happened to coincide with a general nationwide increase in wheeler-dealer activity, often with a fraud component. In this environment the new system attracted precisely the wrong sort of people into the savings and loan business as if designed for this purpose. It would have been hard to invent a system more irresponsible than the one that allowed any half-plausible group to control a savings and loan charter carrying the right to use the government's credit in the prompt attraction of multiple millions, or even billions. This was the financial equivalent of distributing free machine guns in cocaine alley, and many billions of dollars of fraud losses naturally followed.

(11) There also was a grand collapse in oil prices, creating the worst depression since the 1930s in oil-production-dependent areas, which caused many conservative home loans to go into default. Thus, FSLIC would have suffered large (but probably not lethal) losses even if inflation and legislators had never changed the savings and loan system.

(12) To be sure, even under the new system some possibilities remained for regulators or accountants to stop some FSLIC hemorrhages earlier than they actually did. But the accountants were selected and paid by the associations and had professional loyalties to clients as well as concepts. They were understandably loath to enforce death sentences until the negative aspects of complex situations became abundantly clear. And the regulators were overwhelmed by horror cases, being suddenly given the working conditions and triage problems of a M.A.S.H. unit, while receiving modest salaries. Moreover, the medical analogy fits when stretched further. FSLIC was not allowed by Congress to take much appropriate early corrective action. Just like certain savings and loan managements, Congress did not want to face the consequences — for instance, increased taxes — of honest bookkeeping and rational action. Indeed, many legislators intervened directly with the Federal Home Loan Bank system to protect particular fools or crooks, or merely unlucky savings and loan operators, from unpleasant consequences of insolvency. Thus FSLIC was not only like a doctor working under M.A.S.H.-unit conditions but also like such a doctor

forbidden to cause new pain, however brief, or make any blood transfusions (as distinguished from promises regarding future blood transfusions).

(13) The final result for FSLIC could easily be a loss of over $100 billion in a continuously unfolding financial mess that is among the greatest in U.S. history. Even some recently "rescued" associations, with new owners, are likely to cause new FSLIC losses at some later time — losses caused by the speculative temperaments of new managements attracted by loose asset-deployment rules.

While the Federal Home Loan Bank Board failed to prevent the insolvency of FSLIC, that insolvency was probably unpreventable, given its macroeconomic origin and subsequent conduct of legislators. FSLIC's "rescues," although imperfect, were probably as wise as could be expected under M.A.S.H.-unit conditions with no new blood available. There is an O. Henry short story in which God treats as a false arrest the bringing before Him of a miscreant young woman and sends the Heavenly Policeman back to bring in the real culprit, the neglectful father who raised her wrong. So also with the FSLIC mess. The important miscreants are not the crooks and fools who are always with us or the overburdened industry regulators. The real culprits are the ignorant, self-absorbed industry executives and state and federal legislators who should have known better than to let the system be crafted as it was. They also should have acted earlier to correct obvious errors, instead of becoming accessories after the fact.

In retrospect, it is clear that some of the very worst behavior of all, in the years when the FSLIC mess was created, was that of the United States League of Savings Institutions. The League combined a blind loyalty to silly ideas with a blind loyalty to member associations — a loyalty which usually treated the admirable and the despicable as if they were just the same. Acting with such "loyalty to a fault", the League was an effective foe of proper regulatory and legislative response. We are ashamed to report that during the whole period Mutual Savings paid its League dues promptly and voiced little objection to League conduct. This paragraph is a minor effort at atonement.

By silence we acquiesced wrongly as the League took antisocial positions which it incorrectly believed consistent with the long-term interest of the savings and loan industry. Our future behavior will be a little better: If the League does not act more responsibly in the future, Mutual Savings will resign.

It does not follow, we think, from FSLIC's troubles that federal controllers are likely to ruin Freddie Mac. FSLIC was very sick from causes outside the regulators' control, whereas Freddie Mac is flourishing. And Congress, better later than never, is now plainly chary of further loosening, and in fact desires to tighten, asset quality standards in the savings and loan industry and its regulatory apparatus.

Freddie Mac is now regarded in the mortgage, mortgage-securities and debt-issuing markets as a virtually risk-free government agency, even though its obligations are not technically backed by the full faith and credit of the United States. With this enormous advantage, Freddie Mac's controllers can almost always get socially constructive and financially rewarding results, provided they refrain from taking significant risk of ruining Freddie Mac's credit. The annual dividend to private owners is peanuts, a small fraction of 1%, compared to the financing Freddie Mac provides to buyers of housing. The need for the dividend's safety and growth disciplines the system in exactly the right way. There is no reason to change course. Moreover, the right course, involving continued tough credit standards, has been clearly demonstrated by the recent terrible home loan experience in oil-production-dependent areas. Conventionally-sound home loans then went sour in massive quantities, despite having been made by wise and honorable lenders to home buyers with good jobs and loan-payment histories who made substantial down payments. Such experience reinforces the margin-of-safety principle required of highly leveraged institutions that guarantee credit. Just as bank credit standards remained sound for a long time after the horrors of the 1930s, home lending standards enforced by Freddie Mac may remain sound for a long time after the good-home-loan losses of the 1980s. If so, and if interest-rate-change risk is scrupulously minimized, Freddie Mac stock could be a good long-term investment for Mutual Savings.

Our discussion of reasoning regarding investment in Freddie Mac is an anomaly within the Berkshire Hathaway group. Normally, we do not disclose such reasoning. We fear bad effects on future investment buying or investment selling. (We also avoid display of our frequent mental inadequacies, but that is not the reason for the policy.) We depart from usual practice only because we have acquired a full investment position and we do not anticipate an increase in the legal limit which prevents us from buying more stock of Freddie Mac. Under these conditions, we are all for disclosure. But we are *not* recommending that Wesco shareholders purchase Freddie Mac stock. We never want to encourage Wesco shareholders to copy Wesco investments in their own personal accounts.

The first attempt at resolution by the federal government of the FSLIC insolvency will be made when new laws are enacted in 1989. The new laws will probably contain a combination of elements selected from the following list:

(1) sharp increase in deposit-insurance premiums payable to FSLIC;

(2) higher equity capital requirements for associations, with no credit for intangibles, and with prompt asset reduction required when the equity-capital minimum is breached;

(3) drastic reduction in investment powers to limit risky assets (including "junk bonds"), plus close monitoring of risk-prone associations;

(4) strict limits on annual growth of savings deposits;

(5) bans on use of brokers to bring in deposits;

(6) tougher accounting standards, including more bans on "front-ending" into reported income of fees paid in exchange for long-term commitments;

(7) tougher, more summary close-out procedures for associations, including those that are impaired but not insolvent;

(8) more insulation of regulation and close-out cases from interference by individual members of Congress;

(9) changes in control of regulation within the federal bureaucracy, aimed at toughening of regulatory practice, including more concentration of resources on obvious high-risk cases;

(10) a moratorium on approvals of new savings and loan charters; and

(11) more override of state law by federal law.

All the foregoing, except sharply higher deposit-insurance premiums, would clearly tend to reduce future FSLIC losses and should, as a minimum, be included in any half-sensible 1989 attempt to fix FSLIC. Payment to FSLIC of sharply higher deposit-insurance premiums would provide mixed results. On the one hand, FSLIC would get new revenue to help discharge liability from foolish insurance practices in the past. On the other hand, it is not clear how much net new revenue would be available. Sharply higher deposit-insurance premiums would also increase future FSLIC losses by increasing pressure on associations to acquire higher-risk assets promising the higher yields necessary to cover higher premiums. If deposit-insurance premiums are increased by ¼% per annum on total liabilities (which could happen) it will sound trifling and not very threatening to solvency. But associations' net worth, where it exists, is not owned by the government and may be withdrawn by its owners from the savings and loan industry. And, ignoring revenue from assets matching net worth, many associations now look at net profits vs. total liabilities at the rate of ¼% per annum as an unattainable dream. After all, the associations face aggressive competing institutions which either have lower costs, like money-market funds (which do not pay deposit-insurance premiums), or have more experience in maximizing safe yields, like banks. Starting from this not-so-hot competitive position and seeking not-so-obvious ways to stretch yields by ¼% per annum, many associations would, almost surely, be pressed into significant incremental losses. Others would quit the savings and loan business because of below-market returns being earned on shareholders' equity, and any equity capital withdrawn from the system would no longer "buffer" FSLIC against losses.

The would-be FSLIC fixers, as they set increased deposit-insurance premiums, will face the same basic question faced by a keeper of sheep. But, unlike the sheepkeeper, the government lacks knowledge to guide prediction of the point at which additional closeness of shearing will be contrary to the interests of the shearer. This leaves an important question: When you don't know for sure what the sheep can stand, how much safety margin do you leave before you set the shears, shear the whole herd, and send it forth to fare as it will?

The politics of the current scene seem to us to create more wishful thinking than sound thinking. We do not believe that the legislation adopted in 1989 will be likely to prevent recurrence of big trouble at FSLIC.

First, consider again the record of our modern legislators, the would-be FSLIC fixers. They started with a system designed to limit association insolvencies by both:

(1) protecting associations from full competition (a brutal force in a fungible commodity business, with money being the ultimate fungible commodity) and full taxes; and

(2) requiring associations to deploy assets in a very low-risk way.

Despite noting that this combination of carrot and stick kept the donkey under reasonable control for a long time, as it was designed to do after the insolvencies which followed excesses in the 1920s, the modern legislators actually removed the stick from the loss-control system in an attempt to compensate for the loss of the carrot. They also neglected, for a considerable period after interest rates of liabilities were unleashed, the obvious need to allow floating interest rates on home loan assets. And they acted, while they did this, as if they preferred to entice new thieves and megalomaniacs into coverage by federal deposit insurance and also to expand, as fast as possible, the operations of thieves and megalomaniacs already insured. Then, as FSLIC losses mounted, $10 billion or so at a time, the legislators delayed, and delayed, while going along with almost every form of foolish, paper-it-over expediency. And now, finally, we hear many cries for scapegoats in the "any one but me" category. We hear almost no cries for re-examination of assumptions (including re-examination in the form of (i) study of savings and loan systems which have worked better, like England's and (ii) consideration of alternatives such as forcing the private pension system, a huge savings pool which still possesses the carrot of tax exemption and can better bear interest rate crunches, to commit a share of assets to home loans, instead of high-turnover stock trading and the super-leveraging of corporate America, and (iii) consideration of other more extreme alternatives which fit modern facts). Instead, the first proposal, meeting tacit acceptance, is that any federal fix must qualify for mickey-mouse, off-budget accounting which will increase ultimate federal cost. This is not a fixing record which creates confidence in the fixers.

Second, consider the difficulty of the problem faced. As suggested earlier, that problem may well be a "lalapaloosa" which would not yield to the efforts of fixers much better than those we have. When you mix certain elements in a certain way you get sulfuric acid, wish it or not, and there are similar "impotency principles" in microeconomic systems. Under modern conditions it is quite conceivably impossible to create a deposit-insured savings and loan system, successful over the long term, which includes all the elements (for instance "capped" interest rates for borrowers in long-term loans) that a politically sensitive body will want to preserve. Thus the legislative fix attempted in 1989 may be only a more sophisticated version of the attempt of the rustic legislator, aiming at facilitation of education, who proposed a law rounding Pi to an even three. The derision of this example is aimed not so much at our legislators as at the normal working of the human mind. In the presence of complexity the ability to unlearn a once-successful idea is seldom found. Max Planck, the Nobel laureate, noted that even in physics, wherein the ablest of mankind are sworn as their highest duty to improve ideas to fit facts, you never really changed the minds of most of the old professors. Instead, the wide acceptance of correct new ideas had to wait for new professors who had less to unlearn.

Our views are that the problem faced is hard and that everyone has "unlearning difficulty." These views, of course, may have been shaped by our own thinking record. If the problem is not difficult, and if unlearning is easy, we would have difficulty excusing ourselves for the clobbering Mutual Savings took from interest rate change in the early 1980s.

If our predictions are right, Wesco shareholders can pretty well count on Mutual Savings being harmed not only in 1989 but also at a second and later time. In each case we will face both new deposit-insurance costs and reductions of investment powers caused by insolvencies of a type Mutual Savings never got near.

As legislative changes are made Mutual Savings is likely to be hurt by all three of the following:

(1) wise changes in laws;

(2) unwise changes caused by the problems being more difficult than contentious legislative bodies are able or willing to think through; and

(3) unwise changes caused by vindictive legislative reaction to the size of the mess.

We fear changes in the last category because we so often see verifications of the iron prediction (roughly recalled) of the Victorian prime minister: "Those who will not face improvements because they are changes will face changes that are not improvements."

At least as we operate it, Mutual Savings, ex its investment in Freddie Mac, continues to have mediocre long-term prospects.

Precision Steel

The businesses of Wesco's Precision Steel subsidiary, located in the outskirts of Chicago at Franklin Park, Illinois, contributed $3,167,000 to normal net operating income in 1988, up 29% compared with $2,450,000 in 1987. The increase in 1988 profit occurred in spite of a small decline in pounds of product sold. Revenues were up 14% to $62,694,000.

Under the skilled leadership of David Hillstrom, Precision Steel's businesses in 1988 continued to provide an extraordinary return.

The good financial results have an underlying reason, although not one strong enough to cause the results achieved in the absence of superb management. 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 (for instance, Los Angeles) seek out Precision Steel's service.

It is not common that steel warehouses have results like Precision Steel's, even in a generally good year like 1988. What we have watched under David Hillstrom's leadership is boring, repetitive excellence, year after year. We love to see it and to be associated with him.

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 insurance company, Wesco-Financial Insurance Company ("Wes-FIC"). Another $45 million was invested in 1986 and 1987.

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 1988 exceeded $62 million.

Wes-FIC in 1988 began to write direct business, as distinguished from reinsurance. It is now licensed in Nebraska, Utah and Iowa, but it wrote only $412,000 in direct premiums, all surplus lines coverage (permitted for non-admitted insurers) in Alabama. Earned direct premiums were $108,000.

Wes-FIC's "normal" net income for 1988 was $12,094,000, versus $9,459,000 for 1987. The net "normal" income figures excluded securities gains, net of income taxes, of $6,071,000 (including $4,836,000 realized on sale of Wes-FIC's 9% equity interest in Bowery Savings Bank) in 1988, compared with only $9,000 in securities gains in 1987. These items are reported as "Net Gains on Sales of Securities," below. Wes-FIC's net income benefitted by about $260,000 in 1988, versus $1 million in 1987, because of an unusual adjustment to its income tax provision caused by the Tax Reform Act of 1986.

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.

Wesco continues to expect a reasonable return on its investment over the four years of the Fireman's Fund reinsurance contract. However, the Fireman's Fund contract ends with August in 1989, which will leave Wes-FIC with a "longage" of capital and a shortage of good insurance business. This is not a desired position, but there are worse ones.

All Other "Normal" Net Operating Income

All other "normal" net operating income, net of interest paid and general corporate expenses, increased to $3,609,000 in 1988 from $1,808,000 in 1987. Sources were (1) rents ($2,436,000 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.

Net Gains On Sales Of Securities

Wesco's aggregate net gains on sales of securities, combined, after income taxes, increased to $6,525,000 in 1988 from $1,208,000 in 1987. As noted above, $6,071,000 of these gains were realized in the Wes-FIC insurance subsidiary.

Salomon Inc

On October 1, 1987 Wesco and certain of its wholly owned subsidiaries purchased 100,000 newly issued shares of Series A Cumulative Convertible Preferred Stock, without par value, of Salomon Inc ("Salomon"), at a cost of $100 million. Salomon's primary business is transacted by its subsidiary, Salomon Brothers, a leading securities firm. Our investment was part of a $700 million transaction in which other subsidiaries of Berkshire Hathaway Inc., Wesco's parent, invested $600 million. Principal terms of the transaction included the following: (1) the preferred stock pays dividends at the annual rate of 9%; (2) each preferred share, purchased at a cost of $1,000, will be convertible into 26.31579 shares of Salomon common stock on or after October 31, 1990, or earlier if certain extraordinary events occur; and (3) the preferred stock is subject to mandatory redemption provisions requiring the retirement, at $1,000 per share plus accrued dividends, of 20% of the issue on each October 31, beginning in 1995, so long as any shares of preferred stock remain outstanding.

At the stated conversion price of the preferred stock, a profit (subject to certain procedural requirements) will be realizable whenever, after October 31, 1990, the common stock of Salomon (listed NYSE) trades at over $38 per share. At the time of our commitment to buy the new preferred, the common stock of Salomon was selling in the low 30s. However, shortly after the ink dried on Wesco's new stock certificates, the October 19, 1987 "Black Monday" stock market crash occurred, which caused temporary but substantial operating losses plus a lowered credit rating at Salomon. Although Salomon, among securities firms, suffered only its rough share of the general debacle, its common stock at one time after the crash traded as low as $16⅝.

By the end of 1988 Salomon common stock was trading at $24⅛ after much constructive adjustment of Salomon's business to new conditions.

Salomon's credit as a potential source of preferred dividends and stock redemptions improved during its 1988 recovery, when generally available dividend rates on preferred stock were roughly stable. With Wesco's preferred stock now one year shorter in contractual duration, and its conversion privilege enhanced in value during the year, we believe that the fair market value of Wesco's investment was somewhat in excess of its cost, and that the aggregate amount of any such excess was not material to Wesco, at December 31, 1988.

Berkshire Hathaway's Chairman, Warren Buffett, and the undersigned joined the board of Salomon on October 28, 1987, and are very pleased with the new association.

New Subsidiary

At the close of 1988, Wesco acquired 80% of the stock of New America Electrical Corporation ("New America Electric") for a price of $8,200,000. Of this price [illegible],165,000 was cash paid to a liquidating trust for the former shareholders of New America Fund and $1,035,000 was a ten-year, 10% note payable to Glen Mitchel, CEO of New America Electric, who retains the 20% of New America Electric not acquired by Wesco. The pattern of this acquisition is getting to be a common one within the Berkshire Hathaway group, where we are willing to be an 80% owner in many a business we would not be in if we did not admire and trust people who retain the other 20% and are expected to continue to operate the business, with little help and no hindrance from us.

Glen Mitchel is a long-time friend and trusted and admired business associate of the undersigned, Wesco's CEO. Indeed, because Wesco's CEO and his family owned more of New America Electric than Wesco, our whole transaction was approved by the Wesco board with the recommendation and participation of Warren Buffett, CEO and major shareholder of Berkshire Hathaway Inc., Wesco's parent company. Mr. Buffett had no financial interest in New America Electric, and he, plus Messrs. Munger and Mitchel, all believed that $10,250,000 was a fair valuation for 100% of New America Electric at yearend 1988.

New America Electric is a manufacturer of various electrical products including switchgear, circuit breakers, lighting ballasts and starters and electrical equipment for marinas and mobile home and recreational vehicle parks. Its facilities are in Orange County, California.

New America Electric has a present book net worth of about $6,400,000, including over $2,500,000 in cash, and a long history of earning high returns on capital, but with current earnings reduced by conditions approaching those of severe price war. Fortunately, New America Electric is a very low-cost producer. Its size is not material (in accounting parlance) to Wesco; so we have not yet determined future reporting practice. At a minimum, essential information will be discussed each year in the Annual Report's Letter to Shareholders.

This acquisition became available to Wesco because Glen Mitchel preferred minority (20%) ownership of a Berkshire Hathaway group subsidiary instead of dominant 30% ownership in New America Electric, with all other New America Electric stock pretty well scattered through a new public offering, which was the alternative offered. We will try to deserve Glen Mitchel's confidence.

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 the accompanying financial statements, the aggregate market value of Wesco's marketable equity securities was higher than their aggregate carrying value at December 31, 1988 by about $54 million, up significantly from about $6 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 $62 million. As earlier noted, about $57 million of this unrealized appreciation lies within the savings and loan subsidiary, and includes $49.5 million of appreciation in stock of Freddie Mac.

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 ($4,751,000 at 9.25% fixed) against this real estate now exceeding its depreciated carrying value ($2,937,000) in Wesco's balance sheet at December 31, 1988, 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 99% 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 seldom present.

As indicated in Schedule I accompanying Wesco's financial statements, investments, both those in the savings and loan and insurance 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 10% in 1986-88, was dependent to a significant extent on securities gains, irregular by nature.

The considerable, and higher than desired, 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. 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, our approach continues to be applied to no great base position. Wesco has only a tiny fraction of its total intrinsic value in businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, Berkshire Hathaway Inc., Wesco's parent corporation, has a larger proportion of its intrinsic value in durable high-return businesses.

Some historical explanation for the current situation should be repeated here. When Wesco's parent corporation acquired control, Wesco's activities were almost entirely limited to holding (1) some surplus cash, plus (2) a multi-branch savings and loan association which had many very long-term, fixed-rate mortgages, offset by interest-bearing demand deposits. The acquisition of this intrinsically disadvantageous position was unwisely made, alternative opportunities considered, because the acquirer (including the signer of this letter) was overly influenced by a price considered to be moderately below liquidating value. Under such circumstances, acquisitions have a way of producing, on average, for acquirers who are not quick-turn operators, low to moderate long-term results. This happens because any advantage from a starting "bargain" gets swamped by effects from change-resistant mediocrity in the purchased business. Such normal effects have not been completely avoided at Wesco, despite some successful activities, including a large gain in 1985 from an investment in General Foods.

A corporation like Wesco, with no significant proportion of intrinsic value in great businesses, continues to be like a tortoise in a race of hares. And, as we have plainly demonstrated, this particular tortoise is not very sprightly.

On January 26, 1989, Wesco increased its regular quarterly dividend from 18½ cents per share to 19½ cents per share, payable March 7, 1989, to shareholders of record as of the close of business on February 10, 1989.

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 24, 1989

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

	1984	1985	1986	1987	1988
Revenues:					
Sales and service revenues	$ 496,971	$ 504,872	$1,219,252	$1,326,829	$1,407,642
Insurance premiums earned........	140,242	317,059	823,884	824,895	584,235
Investment income-insurance group .	69,281	95,422	107,495	152,995	231,907
Total revenues	747,252	968,583	2,231,444	2,402,944	2,333,222
Earnings:					
Before realized investment gain	$ 70,201	$ 92,948	$ 131,464	$ 214,746	$ 313,441
Realized investment gain	78,694	342,867	150,897	19,806	85,829
Net earnings	$ 148,895	$ 435,815	$ 282,361	$ 234,552	$ 359,270
Common shares outstanding — average in thousands	1,147	1,147	1,147	1,147	1,147
Earnings per share:					
Before realized investment gain	$ 61.21	$ 81.04	$ 114.62	$ 187.24	$ 273.37
Net earnings	129.82	379.99	246.19	204.51	348.23
Year-end data:					
Total assets	$2,297,516	$3,480,789	$4,931,354	$5,863,235	$6,816,848
Term debt and other borrowings ...	127,104	117,879	260,170	289,886	480,009
Minority shareholders' interest.....	34,687	45,818	54,187	57,126	66,396
Shareholders' equity — total......	1,271,761	1,885,330	2,377,797	2,841,659	3,410,108
Shares of common stock outstanding — in thousands	1,147	1,147	1,147	1,147	1,146
Shareholders' equity per outstanding share	$ 1,109	$ 1,644	$ 2,073	$ 2,477	$ 2,975

Data for the years 1984 through 1987 have been restated and reclassified as required for conformity.

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.

BERKSHIRE HATHAWAY INC.

DIRECTORS

WARREN E. BUFFETT, *Chairman*
Chief Executive Officer of Berkshire

CHARLES T. MUNGER, *Vice Chairman*
Chairman and Chief Executive Officer of certain subsidiaries of Berkshire
Chairman of the Board of Directors of Daily Journal Corporation, publisher of specialty newspapers in California

KENNETH V. CHACE
Retired, Former Chief Operating Officer of Textile Operations of Berkshire

MALCOM G. CHACE, JR.
Retired, Former Chairman of Berkshire's Board

J. VERNE McKENZIE
Chief Financial Officer of Berkshire

WALTER SCOTT, JR.
Chairman and Chief Executive Officer of Peter Kiewit Sons', Inc., engaged worldwide in construction, mining, packaging and timberlands.

OFFICERS

WARREN E. BUFFETT, *Chairman and CEO*
CHARLES T. MUNGER, *Vice Chairman*
ROBERT H. BIRD, *Vice President*
MICHAEL A. GOLDBERG, *Vice President*
STANFORD LIPSEY, *Vice President*
J. VERNE McKENZIE, *Vice President, Secretary*
J. WILLIAM SCOTT, *Vice President*
MARC D. HAMBURG, *Treasurer*
DANIEL J. JAKSICH, *Controller*

COMMON STOCK

Stock Transfer Agent and Registrar

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

Shareholders

The Company had approximately 5,500 record holders of its common stock at February 24, 1989. Record owners included three nominees holding 126,586 shares on behalf of beneficial-but-not-of-record owners. Available information indicates that the number of non-record owners was somewhat in excess of the number of record owners, so that the company has at least 11,000 beneficial owners.

Market Prices

The listing for trading on the New York Stock Exchange of the common stock of Berkshire Hathaway Inc. — symbol BRK — was effective November 29, 1988. (See Pages 50 and 51 within this report.) Prior to the NYSE listing, the stock was traded in the over the counter market. Following are the high and low selling prices for the shares during each quarter of 1988 and 1987.

1988	*High*	*Low*	*1987*	*High*	*Low*
First Quarter	$3,500	$3,000	First Quarter	$3,630	$2,800
Second Quarter	4,150	3,400	Second Quarter	3,530	3,330
Third Quarter	5,000	4,040	Third Quarter	4,220	3,420
Fourth Quarter	5,050	4,600	Fourth Quarter	4,270	2,550

NYSE Trading Practices

The New York Stock Exchange specialist in Berkshire stock currently maintains a post opening policy whereby the spread between bid and asked prices is no greater than fifty points and where the difference between round lot sales does not exceed twenty-five points. Furthermore, odd lot market orders (i.e. orders for less than ten shares) are executed at the bid or asked price. For example, when the market is $4800 bid and $4850 asked, a market order to sell one to nine shares is filled at $4800, and a market order to buy one to nine shares is filled at $4850.

Dividends

Berkshire has not declared a cash dividend since 1967.

BERKSHIRE HATHAWAY INC.

Executive Offices — 1440 Kiewit Plaza, Omaha, Nebraska 68131

Reg. S-K
Item 601
Exhibit 19

BERKSHIRE HATHAWAY INC.
Written Description of Oral Amendment to
Bonus Arrangement with Michael A. Goldberg

The bonus arrangement with Michael A. Goldberg was orally amended in 1988 in the following respect:

> In computing profit of the Insurance Group's continuing primary insurance operations, a reduction in the amount of policyholder funds deemed to generate investment income will be computed and effected, equal to the prepaid Federal income taxes that result for those operations from applying provisions of the 1986 Tax Reform Act relating to (a) loss and loss expense reserve discounting methodology, and (b) acceleration into taxable income of a portion of unearned premiums.

Reg. S-K
Item 601
Exhibit 22

BERKSHIRE HATHAWAY INC.
Subsidiaries of Registrant (1)
December 31, 1988

Company Name	State of Incorporation
BHSF Inc.	Delaware
Blue Chip Stamps	California
Campbell Hausfeld/Scott Fetzer Company	Delaware
Columbia Insurance Company	Nebraska
Continental Divide Insurancce Company	Colorado
Cornhusker Casualty Company	Nebraska
Cypress Insurance Company	California
The Fechheimer Brothers Company (2)	Delaware
Kansas Fire & Casualty Company	Kansas
Mutual Savings and Loan Association	California
National Fire & Marine Insurance Company	Nebraska
National Indemnity Company	Nebraska
National Indemnity Company of Florida	Florida
National Indemnity Company of Minnesota	Minnesota
National Liability and Fire Insurance Company	Illinois
Nebraska Furniture Mart, Inc.	Nebraska
Redwood Fire and Casualty Insurance Company	Nebraska
The Scott Fetzer Company	Delaware
Scott Fetzer Financial Group, Inc.	Delaware
See's Candies, Inc.	California
See's Candy Shops, Incorporated	California
Wesco Financial Corporation	Delaware
Wesco-Financial Insurance Company	Nebraska
Wesco Holdings Midwest Inc.	Nebraska
World Book/Scott Fetzer Company	Nebraska

(1) Each of the named subsidiaries is not necessarily a "significant subsidiary" as defined in Rule 1-02(v) of Regulation S-X, and Berkshire has several additional subsidiaries not named above. The unnamed subsidiaries, considered in the aggregate as a single subsidiary, would not constitute a "significant subsidiary" at the end of the year covered by this report.

(2) The names have been omitted of 28 wholly-owned U.S. subsidiaries of The Fechheimer Brothers Company, each of whom operate in the business of uniform manufacturing and/or distribution.

END