BERKSHIRE HATHAWAY INC.

1990
ANNUAL REPORT

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. Investment portfolios of insurance subsidiaries include meaningful ownership percentages of other publicly traded companies.

Additionally, Berkshire Hathaway publishes the *Buffalo News*, a daily and Sunday newspaper circulated in upstate New York, and a number of Berkshire subsidiaries conduct substantial business activities unrelated to the insurance business. These include: the manufacture and distribution of *Fechheimer Bros.* uniforms, of *Kirby* home cleaning systems and of *See's* fine chocolate candy; also, the publication and distribution of *World Book* encyclopedias and other reference materials; the retailing of home furnishings and the retailing of fine jewelry. A savings and loan business is conducted in Pasadena, California by a subsidiary of Wesco Financial Corporation, a publicly traded and 80.1% owned subsidiary of Berkshire. The Scott Fetzer Financial Group, 100% owned by Berkshire, provides financing for buyers of *World Book* and *Kirby* products.

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.

BERKSHIRE HATHAWAY INC.

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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.")

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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.

BERKSHIRE HATHAWAY INC.

Selected Financial Data at Five Year Intervals
(dollars in thousands, except per share amounts)

	1965	1970	1975	1980	1985	1990
Revenues:						
Sales and service revenues	$ 49,301	$ 24,569	$ 32,833	$ 300,837	$ 504,872	$ 1,580,074
Insurance premiums earned	—	39,173	58,336	185,187	317,059	591,540
Investment income, insurance group	—	3,077	8,493	31,111	95,422	335,930
Realized investment gain (loss)	—	58	(2,888)	14,706	495,055	33,989
Total revenues	$ 49,301	$ 67,280	$ 97,486	$ 597,082	$1,463,638	$ 2,659,472
Earnings (loss):						
Before realized investment gain	$ 2,279	$ 4,507	$ 6,714	$ 43,215	$ 92,948	$ 370,745
Realized investment gain (loss)	—	58	(2,022)	9,907	342,867	23,348
Net earnings	$ 2,279	$ 4,565	$ 4,692	$ 53,122	$ 435,815	$ 394,093
Earnings (loss) per share:						
Before realized investment gain	$ 2.24	$ 4.60	$ 6.85	$ 42.07	$ 81.04	$ 323.39
Realized investment gain (loss)	—	0.06	(2.06)	9.65	298.95	20.36
Net earnings	$ 2.24	$ 4.66	$ 4.79	$ 51.72	$ 379.99	$ 343.75
Year-end data:						
Total assets	$ 28,222	$113,212	$225,741	$1,309,066	$3,480,789	$10,670,423
Term debt and other borrowings	—	5,891	24,108	180,251	117,879	1,239,358
Shareholders' equity	24,520	48,483	92,890	395,214	1,885,330	5,287,454
Common shares outstanding, in thousands	1,017	980	980	986	1,147	1,146
Shareholders' equity per outstanding share	$24	$49	$95	$401	$1,644	$4,612

The 1965 fiscal year was the 52 week period ended October 2, 1965. The years 1970, 1975, 1980 and 1985 were fiscal years that ended on Saturday nearest December 31. Data are presented in conformity with 1990 consolidation and accounting practices; accordingly, certain prior year data have been restated.

BERKSHIRE HATHAWAY INC.

To the Shareholders of Berkshire Hathaway Inc.:

Last year we made a prediction: "A reduction [in Berkshire's net worth] is almost certain in at least one of the next three years." During much of 1990's second half, we were on the road to quickly proving that forecast accurate. But some strengthening in stock prices late in the year enabled us to close 1990 with net worth up by $362 million, or 7.3%. Over the last 26 years (that is, since present management took over) our per-share book value has grown from $19.46 to $4,612.06, or at a rate of 23.2% compounded annually.

Our growth rate was lackluster in 1990 because our four major common stock holdings, in aggregate, showed little change in market value. Last year I told you that though these companies — Capital Cities/ABC, Coca-Cola, GEICO, and Washington Post — had fine businesses and superb managements, widespread recognition of these attributes had pushed the stock prices of the four to lofty levels. The market prices of the two media companies have since fallen significantly — for good reasons relating to evolutionary industry developments that I will discuss later — and the price of Coca-Cola stock has increased significantly for what I also believe are good reasons. Overall, year-end 1990 prices of our "permanent four," though far from enticing, were a bit more appealing than they were a year earlier.

Berkshire's 26-year record is meaningless in forecasting future results; so also, we hope, is the one-year record. We continue to aim for a 15% average annual gain in intrinsic value. But, as we never tire of telling you, this goal becomes ever more difficult to reach as our equity base, now $5.3 billion, increases.

If we do attain that 15% average, our shareholders should fare well. However, Berkshire's corporate gains will produce an identical gain for a specific shareholder only if he eventually sells his shares at the same relationship to intrinsic value that existed when he bought them. For example, if you buy at a 10% premium to intrinsic value; if intrinsic value subsequently grows at 15% a year; and if you then sell at a 10% premium, your own return will correspondingly be 15% compounded. (The calculation assumes that no dividends are paid.) If, however, you buy at a premium and sell at a smaller premium, your results will be somewhat inferior to those achieved by the company.

Ideally, the results of every Berkshire shareholder would closely mirror those of the company during his period of ownership. That is why Charlie Munger, Berkshire's Vice Chairman and my partner, and I hope for Berkshire to sell consistently at about intrinsic value. We prefer such steadiness to the value-ignoring volatility of the past two years: In 1989 intrinsic value grew less than did book value, which was up 44%, while the market price rose 85%; in 1990 book value and intrinsic value increased by a small amount, while the market price fell 23%.

Berkshire's intrinsic value continues to exceed book value by a substantial margin. We can't tell you the exact differential because intrinsic value is necessarily an estimate; Charlie and I might, in fact, differ by 10% in our appraisals. We do know, however, that we own some exceptional businesses that are worth considerably more than the values at which they are carried on our books.

Much of the extra value that exists in our businesses has been created by the managers now running them. Charlie and I feel free to brag about this group because we had nothing to do with developing the skills they possess: These superstars just came that way. Our job is merely to identify talented managers and provide an environment in which they can do their stuff. Having done it, they send their cash to headquarters and we face our only other task: the intelligent deployment of these funds.

My own role in operations may best be illustrated by a small tale concerning my granddaughter, Emily, and her fourth birthday party last fall. Attending were other children, adoring relatives, and Beemer the Clown, a local entertainer who includes magic tricks in his act.

Beginning these, Beemer asked Emily to help him by waving a "magic wand" over "the box of wonders." Green handkerchiefs went into the box, Emily waved the wand, and Beemer removed blue ones. Loose handkerchiefs went in and, upon a magisterial wave by Emily, emerged knotted. After four such transformations, each more amazing than its predecessor, Emily was unable to contain herself. Her face aglow, she exulted: "Gee, I'm really good at this."

And that sums up my contribution to the performance of Berkshire's business magicians — the Blumkins, the Friedman family, Mike Goldberg, the Heldmans, Chuck Huggins, Stan Lipsey and Ralph Schey. They deserve your applause.

Sources of Reported Earnings

The table below shows the major sources of Berkshire's reported earnings. In this presentation, 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 one utilizing generally accepted accounting principles (GAAP), which require purchase-price adjustments to be made 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.

Much additional information about these businesses is given on pages 39 - 46, where 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 56. His letter also contains the clearest and most insightful discussion of the banking industry that I have seen.

	(000s omitted)			
	Pre-Tax Earnings		*Berkshire's Share of Net Earnings (after taxes and minority interests)*	
	1990	*1989*	*1990*	*1989*
Operating Earnings:				
Insurance Group:				
Underwriting	$ (26,647)	$ (24,400)	$ (14,936)	$ (12,259)
Net Investment Income	327,047	243,599	282,613	213,642
Buffalo News	43,954	46,047	25,981	27,771
Fechheimer	12,450	12,621	6,605	6,789
Kirby	27,445	26,114	17,613	16,803
Nebraska Furniture Mart	17,248	17,070	8,485	8,441
Scott Fetzer Manufacturing Group	30,378	33,165	18,458	19,996
See's Candies	39,580	34,235	23,892	20,626
Wesco - other than Insurance	12,441	13,008	9,676	9,810
World Book	31,896	25,583	20,420	16,372
Amortization of Goodwill	(3,476)	(3,387)	(3,461)	(3,372)
Other Purchase-Price Accounting Charges	(5,951)	(5,740)	(6,856)	(6,668)
Interest Expense*	(76,374)	(42,389)	(49,726)	(27,098)
Shareholder-Designated Contributions	(5,824)	(5,867)	(3,801)	(3,814)
Other	58,310	23,755	35,782	12,863
Operating Earnings	482,477	393,414	370,745	299,902
Sales of Securities	33,989	223,810	23,348	147,575
Total Earnings - All Entities	$ 516,466	$ 617,224	$ 394,093	$ 447,477

**Excludes interest expense of Scott Fetzer Financial Group and Mutual Savings & Loan.*

We refer you also to pages 47 - 53, where we have rearranged Berkshire's financial data into four segments. These correspond to the way Charlie and I think about the business and should help you more in estimating Berkshire's intrinsic value than consolidated figures would do. Shown on these pages are balance sheets and earnings statements for: (1) our insurance operations, with their major investment positions itemized; (2) our manufacturing, publishing and retailing businesses, leaving aside certain non-operating assets and purchase-price accounting adjustments; (3) our subsidiaries engaged in finance-type operations, which are Mutual Savings and Scott Fetzer Financial; and (4) an all-other category that includes the non-operating assets (primarily marketable securities) held by the companies in segment (2), all purchase-price accounting adjustments, and various assets and debts of the Wesco and Berkshire parent companies.

If you combine the earnings and net worths of these four segments, you will derive totals matching those shown on our GAAP statements. However, I want to emphasize that this four-category presentation does not fall within the purview of our auditors, who in no way bless it.

"Look-Through" Earnings

The term "earnings" has a precise ring to it. And when an earnings figure is accompanied by an unqualified auditor's certificate, a naive reader might think it comparable in certitude to pi, calculated to dozens of decimal places.

In reality, however, earnings can be as pliable as putty when a charlatan heads the company reporting them. Eventually truth will surface, but in the meantime a lot of money can change hands. Indeed, some important American fortunes have been created by the monetization of accounting mirages.

Funny business in accounting is not new. For connoisseurs of chicanery, I have attached as Appendix A on page 22 a previously unpublished satire on accounting practices written by Ben Graham in 1936. Alas, excesses similar to those he then lampooned have many times since found their way into the financial statements of major American corporations and been duly certified by big-name auditors. Clearly, investors must always keep their guard up and use accounting numbers as a beginning, not an end, in their attempts to calculate true "economic earnings" accruing to them.

Berkshire's own reported earnings are misleading in a different, but important, way: We have huge investments in companies ("investees") whose earnings far exceed their dividends and in which we record our share of earnings only to the extent of the dividends we receive. The extreme case is Capital Cities/ABC, Inc. Our 17% share of the company's earnings amounted to more than $83 million last year. Yet only about $530,000 ($600,000 of dividends it paid us less some $70,000 of tax) is counted in Berkshire's GAAP earnings. The residual $82 million-plus stayed with Cap Cities as retained earnings, which work for our benefit but go unrecorded on our books.

Our perspective on such "forgotten-but-not-gone" earnings is simple: The way they are accounted for is of no importance, but their ownership and subsequent utilization is all-important. We care not whether the auditors hear a tree fall in the forest; we do care who owns the tree and what's next done with it.

When Coca-Cola uses retained earnings to repurchase its shares, the company increases our percentage ownership in what I regard to be the most valuable franchise in the world. (Coke also, of course, uses retained earnings in many other value-enhancing ways.) Instead of repurchasing stock, Coca-Cola could pay those funds to us in dividends, which we could then use to purchase more Coke shares. That would be a less efficient scenario: Because of taxes we would pay on dividend income, we would not be able to increase our proportionate ownership to the degree that Coke can, acting for us. If this less efficient procedure were followed, however, Berkshire would report far greater "earnings."

I believe the best way to think about our earnings is in terms of "look-through" results, calculated as follows: Take $250 million, which is roughly our share of the 1990 operating earnings retained by our investees; subtract $30 million, for the incremental taxes we would have owed had that $250 million been paid to us in dividends; and add the remainder, $220 million, to our reported operating earnings of $371 million. Thus our 1990 "look-through earnings" were about $590 million.

As I mentioned last year, we hope to have look-through earnings grow about 15% annually. In 1990 we substantially exceeded that rate but in 1991 we will fall far short of it. Our Gillette preferred has been called and we will convert it into common stock on April 1. This will reduce reported earnings by about $35 million annually and look-through earnings by a much smaller, but still significant, amount. Additionally, our media earnings — both direct and look-through — appear sure to decline. Whatever the results, we will post you annually on how we are doing on a look-through basis.

Non-Insurance Operations

Take another look at the figures on page 51, which aggregate the earnings and balance sheets of our non-insurance operations. After-tax earnings on average equity in 1990 were 51%, a result that would have placed the group about 20th on the 1989 Fortune 500.

Two factors make this return even more remarkable. First, leverage did not produce it: Almost all our major facilities are owned, not leased, and such small debt as these operations have is basically offset by cash they hold. In fact, if the measurement was return on assets — a calculation that eliminates the effect of debt upon returns — our group would rank in Fortune's top ten.

Equally important, our return was not earned from industries, such as cigarettes or network television stations, possessing spectacular economics for all participating in them. Instead it came from a group of businesses operating in such prosaic fields as furniture retailing, candy, vacuum cleaners, and even steel warehousing. The explanation is clear: Our extraordinary returns flow from outstanding operating managers, not fortuitous industry economics.

Let's look at the larger operations:

- It was a poor year for retailing — particularly for big-ticket items — but someone forgot to tell Ike Friedman at Borsheim's. Sales were up 18%. That's both a same-stores and all-stores percentage, since Borsheim's operates but one establishment.

But, oh, what an establishment! We can't be sure about the fact (because most fine-jewelry retailers are privately owned) but we believe that this jewelry store does more volume than any other in the U.S., except for Tiffany's New York store.

Borsheim's could not do nearly that well if our customers came only from the Omaha metropolitan area, whose population is about 600,000. We have long had a huge percentage of greater Omaha's jewelry business, so growth in that market is necessarily limited. But every year business from non-Midwest customers grows dramatically. Many visit the store in person. A large number of others, however, buy through the mail in a manner you will find interesting.

These customers request a jewelry selection of a certain type and value — say, emeralds in the $10,000-$20,000 range — and we then send them five to ten items meeting their specifications and from which they can pick. Last year we mailed about 1,500 assortments of all kinds, carrying values ranging from under $1,000 to hundreds of thousands of dollars.

The selections are sent all over the country, some to people no one at Borsheim's has ever met. (They must always have been well recommended, however.) While the number of mailings in 1990 was a record, Ike has been sending merchandise far and wide for decades. Misanthropes will be crushed to learn how well our "honor-system" works: We have yet to experience a loss from customer dishonesty.

We attract business nationwide because we have several advantages that competitors can't match. The most important item in the equation is our operating costs, which run about 18% of sales compared to 40% or so at the typical competitor. (Included in the 18% are occupancy and buying costs, which some public companies include in "cost of goods sold.") Just as Wal-Mart, with its 15% operating costs, sells at prices that high-cost competitors can't touch and thereby constantly increases its market share, so does Borsheim's. What works with diapers works with diamonds.

Our low prices create huge volume that in turn allows us to carry an extraordinarily broad inventory of goods, running ten or more times the size of that at the typical fine-jewelry store. Couple our breadth of selection and low prices with superb service and you can understand how Ike and his family have built a national jewelry phenomenon from an Omaha location.

And family it is. Ike's crew always includes son Alan and sons-in-law Marvin Cohn and Donald Yale. And when things are busy — that's often — they are joined by Ike's wife, Roz, and his daughters, Janis and Susie. In addition, Fran Blumkin, wife of Louie (Chairman of Nebraska Furniture Mart and Ike's cousin), regularly pitches in. Finally, you'll find Ike's 89-year-old mother, Rebecca, in the store most afternoons, Wall Street Journal in hand. Given a family commitment like this, is it any surprise that Borsheim's runs rings around competitors whose managers are thinking about how soon 5 o'clock will arrive?

- While Fran Blumkin was helping the Friedman family set records at Borsheim's, her sons, Irv and Ron, along with husband Louie, were setting records at The Nebraska Furniture Mart. Sales at our one-and-only location were $159 million, up 4% from 1989. Though again the fact can't be conclusively proved, we believe NFM does close to double the volume of any other home furnishings store in the country.

The NFM formula for success parallels that of Borsheim's. First, operating costs are rock-bottom — 15% in 1990 against about 40% for Levitz, the country's largest furniture retailer, and 25% for Circuit City Stores, the leading discount retailer of electronics and appliances. Second, NFM's low costs allow the business to price well below all competitors. Indeed, major chains, knowing what they will face, steer clear of Omaha. Third, the huge volume generated by our bargain prices allows us to carry the broadest selection of merchandise available anywhere.

Some idea of NFM's merchandising power can be gleaned from a recent report of consumer behavior in Des Moines, which showed that NFM was Number 3 in popularity among 20 furniture retailers serving that city. That may sound like no big deal until you consider that 19 of those retailers are located in Des Moines, whereas our store is 130 miles away. This leaves customers driving a distance equal to that between Washington and Philadelphia in order to shop with us, even though they have a multitude of alternatives next door. In effect, NFM, like Borsheim's, has dramatically expanded the territory it serves — not by the traditional method of opening new stores but rather by creating an irresistible magnet that employs price and selection to pull in the crowds.

Last year at the Mart there occurred an historic event: I experienced a counterrevelation. Regular readers of this report know that I have long scorned the boasts of corporate executives about synergy, deriding such claims as the last refuge of scoundrels defending foolish acquisitions. But now I know better: In Berkshire's first synergistic explosion, NFM put a See's candy cart in the store late last year and sold more candy than that moved by some of the full-fledged stores See's operates in California. This success contradicts all tenets of retailing. With the Blumkins, though, the impossible is routine.

- At See's, physical volume set a record in 1990 — but only barely and only because of good sales early in the year. After the invasion of Kuwait, mall traffic in the West fell. Our poundage volume at Christmas dropped slightly, though our dollar sales were up because of a 5% price increase.

That increase, and better control of expenses, improved profit margins. Against the backdrop of a weak retailing environment, Chuck Huggins delivered outstanding results, as he has in each of the nineteen years we have owned See's. Chuck's imprint on the business — a virtual fanaticism about quality and service — is visible at all of our 225 stores.

One happening in 1990 illustrates the close bond between See's and its customers. After 15 years of operation, our store in Albuquerque was endangered: The landlord would not renew our lease, wanting us instead to move to an inferior location in the mall and even so to pay a much higher rent. These changes would have wiped out the store's profit. After extended negotiations got us nowhere, we set a date for closing the store.

On her own, the store's manager, Ann Filkins, then took action, urging customers to protest the closing. Some 263 responded by sending letters and making phone calls to See's headquarters in San Francisco, in some cases threatening to boycott the mall. An alert reporter at the Albuquerque paper picked up the story. Supplied with this evidence of a consumer uprising, our landlord offered us a satisfactory deal. (He, too, proved susceptible to a counterrevelation.)

Chuck subsequently wrote personal letters of thanks to every loyalist and sent each a gift certificate. He repeated his thanks in a newspaper ad that listed the names of all 263. The sequel: Christmas sales in Albuquerque were up substantially.

• Charlie and I were surprised at developments this past year in the media industry, including newspapers such as our Buffalo News. The business showed far more vulnerability to the early stages of a recession than has been the case in the past. The question is whether this erosion is just part of an aberrational cycle — to be fully made up in the next upturn — or whether the business has slipped in a way that permanently reduces intrinsic business values.

Since I didn't predict what *has* happened, you may question the value of my prediction about what *will* happen. Nevertheless, I'll proffer a judgment: While many media businesses will remain economic marvels in comparison with American industry generally, they will prove considerably less marvelous than I, the industry, or lenders thought would be the case only a few years ago.

The reason media businesses have been so outstanding in the past was not physical growth, but rather the unusual pricing power that most participants wielded. Now, however, advertising dollars are growing slowly. In addition, retailers that do little or no media advertising (though they sometimes use the Postal Service) have gradually taken market share in certain merchandise categories. Most important of all, the number of both print and electronic advertising channels has substantially increased. As a consequence, advertising dollars are more widely dispersed and the pricing power of ad vendors has diminished. These circumstances materially reduce the intrinsic value of our major media investments and also the value of our operating unit, Buffalo News — though all remain fine businesses.

Notwithstanding the problems, Stan Lipsey's management of the News continues to be superb. During 1990, our earnings held up much better than those of most metropolitan papers, falling only 5%. In the last few months of the year, however, the rate of decrease was far greater.

I can safely make two promises about the News in 1991: (1) Stan will again rank at the top among newspaper publishers; and (2) earnings will fall substantially. Despite a slowdown in the demand for newsprint, the price per ton will average significantly more in 1991 and the paper's labor costs will also be considerably higher. Since revenues may meanwhile be down, we face a real squeeze.

Profits may be off but our pride in the product remains. We continue to have a larger "news hole" — the portion of the paper devoted to news — than any comparable paper. In 1990, the proportion rose to 52.3% against 50.1% in 1989. Alas, the increase resulted from a decline in advertising pages rather than from a gain in news pages. Regardless of earnings pressures, we will maintain at least a 50% news hole. Cutting product quality is not a proper response to adversity.

• The news at Fechheimer, our manufacturer and retailer of uniforms, is all good with one exception: George Heldman, at 69, has decided to retire. I tried to talk him out of it but he had one irrefutable argument: With four other Heldmans — Bob, Fred, Gary and Roger — to carry on, he was leaving us with an abundance of managerial talent.

Fechheimer's operating performance improved considerably in 1990, as many of the problems we encountered in integrating the large acquisition we made in 1988 were moderated or solved. However, several unusual items caused the earnings reported in the "Sources" table to be flat. In the retail operation, we continue to add stores and now have 42 in 22 states. Overall, prospects appear excellent for Fechheimer.

• At Scott Fetzer, Ralph Schey runs 19 businesses with a mastery few bring to running one. In addition to overseeing three entities listed on page 6 — World Book, Kirby, and Scott Fetzer Manufacturing — Ralph directs a finance operation that earned a record $12.2 million pre-tax in 1990.

Were Scott Fetzer an independent company, it would rank close to the top of the Fortune 500 in terms of return on equity, although it is not in businesses that one would expect to be economic champs. The superior results are directly attributable to Ralph.

At World Book, earnings improved on a small decrease in unit volume. The costs of our decentralization move were considerably less in 1990 than 1989 and the benefits of decentralization are being realized. World Book remains far and away the leader in United States encyclopedia sales and we are growing internationally, though from a small base.

Kirby unit volume grew substantially in 1990 with the help of our new vacuum cleaner, The Generation 3, which was an unqualified success. Earnings did not grow as fast as sales because of both start-up expenditures and "learning-curve" problems we encountered in manufacturing the new product. International

business, whose dramatic growth I described last year, had a further 20% sales gain in 1990. With the aid of a recent price increase, we expect excellent earnings at Kirby in 1991.

Within the Scott Fetzer Manufacturing Group, Campbell Hausfeld, its largest unit, had a particularly fine year. This company, the country's leading producer of small and medium-sized air compressors, achieved record sales of $109 million, more than 30% of which came from products introduced during the last five years.

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In looking at the figures for our non-insurance operations, you will see that net worth increased by only $47 million in 1990 although earnings were $133 million. This does not mean that our managers are in any way skimping on investments that strengthen their business franchises or that promote growth. Indeed, they diligently pursue both goals.

But they also never deploy capital without good reason. The result: In the past five years they have funneled well over 80% of their earnings to Charlie and me for use in new business and investment opportunities.

Insurance Operations

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

	Yearly Change in Premiums Written (%)	*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	6.5
1983	5.0	112.0	6.8	3.8
1984	8.5	118.0	16.9	3.8
1985	22.1	116.3	16.1	3.0
1986	22.2	108.0	13.5	2.6
1987	9.4	104.6	7.8	3.1
1988	4.4	105.4	5.5	3.3
1989 (Revised)	3.2	109.2	7.7	4.1
1990 (Est.)	4.5	109.8	5.0	4.1

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. The higher the ratio, the worse the year. When the investment income that an insurer earns from holding 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 at an average of 10% annually, even in periods when general inflation runs considerably lower. (Over the last 25 years, incurred losses have in reality grown at a still faster rate, 11%.) If premium growth meanwhile materially lags that 10% rate, underwriting losses will mount, though the industry's tendency to under-reserve when business turns bad may obscure their size for a time.

Last year premium growth fell far short of the required 10% and underwriting results therefore worsened. (In our table, however, the severity of the deterioration in 1990 is masked because the industry's 1989 losses from Hurricane Hugo caused the ratio for that year to be somewhat above trendline.) The combined ratio will again increase in 1991, probably by about two points.

Results will improve only when most insurance managements become so fearful that they run from business, even though it can be done at much higher prices than now exist. At some point these managements will indeed get the message: The most important thing to do when you find yourself in a hole is to stop digging. But so far that point hasn't gotten across: Insurance managers continue to dig — sullenly but vigorously.

The picture would change quickly if a major physical or financial catastrophe were to occur. Absent such a shock, one to two years will likely pass before underwriting losses become large enough to raise management fear to a level that would spur major price increases. When that moment arrives, Berkshire will be ready — both financially and psychologically — to write huge amounts of business.

In the meantime, our insurance volume continues to be small but satisfactory. In the next section of this report we will give you a framework for evaluating insurance results. From that discussion, you will gain an understanding of why I am so enthusiastic about the performance of our insurance manager, Mike Goldberg, and his cadre of stars, Rod Eldred, Dinos Iordanou, Ajit Jain, and Don Wurster.

In assessing our insurance results over the next few years, you should be aware of one type of business we are pursuing that could cause them to be unusually volatile. If this line of business expands, as it may, our underwriting experience will deviate from the trendline you might expect: In most years we will somewhat exceed expectations and in an occasional year we will fall far below them.

The volatility I predict reflects the fact that we have become a large seller of insurance against truly major catastrophes ("super-cats"), which could for example be hurricanes, windstorms or earthquakes. The buyers of these policies are reinsurance companies that themselves are in the business of writing catastrophe coverage for primary insurers and that wish to "lay off," or rid themselves, of part of their exposure to catastrophes of special severity. Because the need for these buyers to collect on such a policy will only arise at times of extreme stress — perhaps even chaos — in the insurance business, they seek financially strong sellers. And here we have a major competitive advantage: In the industry, our strength is unmatched.

A typical super-cat contract is complicated. But in a plain-vanilla instance we might write a one-year, $10 million policy providing that the buyer, a reinsurer, would be paid that sum only if a catastrophe caused two results: (1) specific losses for the reinsurer above a threshold amount; and (2) aggregate losses for the insurance industry of, say, more than $5 billion. Under virtually all circumstances, loss levels that satisfy the second condition will also have caused the first to be met.

For this $10 million policy, we might receive a premium of, say, $3 million. Say, also, that we take in annual premiums of $100 million from super-cat policies of all kinds. In that case we are very likely in any given year to report either a profit of close to $100 million or a loss of well over $200 million. Note that we are not spreading risk as insurers typically do; we are concentrating it. Therefore, our yearly combined ratio on this business will almost never fall in the industry range of 100 - 120, but will instead be close to either zero or 300%.

Most insurers are financially unable to tolerate such swings. And if they have the ability to do so, they often lack the desire. They may back away, for example, because they write gobs of primary property insurance that would deliver them dismal results at the very time they would be experiencing major losses on super-cat reinsurance. In addition, most corporate managements believe that their shareholders dislike volatility in results.

We can take a different tack: Our business in primary property insurance is small and we believe that Berkshire shareholders, if properly informed, can handle unusual volatility in profits so long as the swings carry with them the prospect of superior long-term results. (Charlie and I always have preferred a lumpy 15% return to a smooth 12%.)

We want to emphasize three points: (1) While we *expect* our super-cat business to produce satisfactory results over, say, a decade, we're *sure* it will produce absolutely terrible results in at least an occasional year; (2) Our expectations can be based on little more than subjective judgments — for this kind of insurance, historical loss data are of very limited value to us as we decide what rates to charge today; and (3) Though we expect to write significant quantities of super-cat business, we will do so only at prices we believe to be commensurate with risk. If competitors become optimistic, our volume will fall. This insurance has, in fact, tended in recent years to be woefully underpriced; most sellers have left the field on stretchers.

At the moment, we believe Berkshire to be the largest U.S. writer of super-cat business. So when a major quake occurs in an urban area or a winter storm rages across Europe, light a candle for us.

Measuring Insurance Performance

In the previous section I mentioned "float," the funds of others that insurers, in the conduct of their business, temporarily hold. Because these funds are available to be invested, the typical property-casualty insurer can absorb losses and expenses that exceed premiums by 7% to 11% and still be able to break even on its business. Again, this calculation excludes the earnings the insurer realizes on net worth — that is, on the funds provided by shareholders.

However, many exceptions to this 7% to 11% range exist. For example, insurance covering losses to crops from hail damage produces virtually no float at all. Premiums on this kind of business are paid to the insurer just prior to the time hailstorms are a threat, and if a farmer sustains a loss he will be paid almost immediately. Thus, a combined ratio of 100 for crop hail insurance produces no profit for the insurer.

At the other extreme, malpractice insurance covering the potential liabilities of doctors, lawyers and accountants produces a very high amount of float compared to annual premium volume. The float materializes because claims are often brought long after the alleged wrongdoing takes place and because their payment may be still further delayed by lengthy litigation. The industry calls malpractice and certain other kinds of liability insurance "long-tail" business, in recognition of the extended period during which insurers get to hold large sums that in the end will go to claimants and their lawyers (and to the *insurer's* lawyers as well).

In long-tail situations a combined ratio of 115 (or even more) can prove profitable, since earnings produced by the float will exceed the 15% by which claims and expenses overrun premiums. The catch, though, is that "long-tail" means exactly that: Liability business written in a given year and presumed at first to have produced a combined ratio of 115 may eventually smack the insurer with 200, 300 or worse when the years have rolled by and all claims have finally been settled.

The pitfalls of this business mandate an operating principle that too often is ignored: Though certain long-tail lines may prove profitable at combined ratios of 110 or 115, insurers will invariably find it unprofitable to price using those ratios as targets. Instead, prices must provide a healthy margin of safety against the societal trends that are forever springing expensive surprises on the insurance industry. Setting a target of 100 can itself result in heavy losses; aiming for 110 - 115 is business suicide.

All of that said, what should the measure of an insurer's profitability be? Analysts and managers customarily look to the combined ratio — and it's true that this yardstick usually is a good indicator of where a company ranks in profitability. We believe a better measure, however, to be a comparison of underwriting loss to float developed.

This loss/float ratio, like any statistic used in evaluating insurance results, is meaningless over short time periods: Quarterly underwriting figures and even annual ones are too heavily based on estimates to be much good. But when the ratio takes in a period of years, it gives a rough indication of the cost of funds generated by insurance operations. A low cost of funds signifies a good business; a high cost translates into a poor business.

On the next page we show the underwriting loss, if any, of our insurance group in each year since we entered the business and relate that bottom line to the average float we have held during the year. From this data we have computed a "cost of funds developed from insurance."

	(1) Underwriting Loss	(2) Average Float	Approximate Cost of Funds	Yearend Yield on Long-Term Govt. Bonds
	(In $ Millions)		(Ratio of 1 to 2)	
1967	profit	$17.3	less than zero	5.50%
1968	profit	19.9	less than zero	5.90%
1969	profit	23.4	less than zero	6.79%
1970	$0.37	32.4	1.14%	6.25%
1971	profit	52.5	less than zero	5.81%
1972	profit	69.5	less than zero	5.82%
1973	profit	73.3	less than zero	7.27%
1974	7.36	79.1	9.30%	8.13%
1975	11.35	87.6	12.96%	8.03%
1976	profit	102.6	less than zero	7.30%
1977	profit	139.0	less than zero	7.97%
1978	profit	190.4	less than zero	8.93%
1979	profit	227.3	less than zero	10.08%
1980	profit	237.0	less than zero	11.94%
1981	profit	228.4	less than zero	13.61%
1982	21.56	220.6	9.77%	10.64%
1983	33.87	231.3	14.64%	11.84%
1984	48.06	253.2	18.98%	11.58%
1985	44.23	390.2	11.34%	9.34%
1986	55.84	797.5	7.00%	7.60%
1987	55.43	1,266.7	4.38%	8.95%
1988	11.08	1,497.7	0.74%	9.00%
1989	24.40	1,541.3	1.58%	7.97%
1990	26.65	1,615.9	1.65%	8.24%

The float figures are derived from the total of loss reserves, loss adjustment expense reserves and unearned premium reserves minus agents' balances, prepaid acquisition costs and deferred charges applicable to assumed reinsurance. At some insurers other items should enter into the calculation, but in our case these are unimportant and have been ignored.

During 1990 we held about $1.6 billion of float slated eventually to find its way into the hands of others. The underwriting loss we sustained during the year was $27 million and thus our insurance operation produced funds for us at a cost of about 1.6%. As the table shows, we managed in some years to underwrite at a profit and in those instances our cost of funds was less than zero. In other years, such as 1984, we paid a very high price for float. In 19 years out of the 24 we have been in insurance, though, we have developed funds at a cost below that paid by the government.

There are two important qualifications to this calculation. First, the fat lady has yet to gargle, let alone sing, and we won't know our true 1967 - 1990 cost of funds until all losses from this period have been settled many decades from now. Second, the value of the float to shareholders is somewhat undercut by the fact that they must put up their own funds to support the insurance operation and are subject to double taxation on the investment income these funds earn. Direct investments would be more tax-efficient.

The tax penalty that indirect investments impose on shareholders is in fact substantial. Though the calculation is necessarily imprecise, I would estimate that the owners of the average insurance company would find the tax penalty adds about one percentage point to their cost of float. I also think that approximates the correct figure for Berkshire.

Figuring a cost of funds for an insurance business allows anyone analyzing it to determine whether the operation has a positive or negative value for shareholders. If this cost (including the tax penalty) is higher

than that applying to alternative sources of funds, the value is negative. If the cost is lower, the value is positive — and if the cost is *significantly* lower, the insurance business qualifies as a very valuable asset.

So far Berkshire has fallen into the significantly-lower camp. Even more dramatic are the numbers at GEICO, in which our ownership interest is now 48% and which customarily operates at an underwriting profit. GEICO's growth has generated an ever-larger amount of funds for investment that have an effective cost of considerably less than zero. Essentially, GEICO's policyholders, in aggregate, pay the company interest on the float rather than the other way around. (But handsome is as handsome does: GEICO's unusual profitability results from its extraordinary operating efficiency and its careful classification of risks, a package that in turn allows rock-bottom prices for policyholders.)

Many well-known insurance companies, on the other hand, incur an underwriting loss/float cost that, combined with the tax penalty, produces negative results for owners. In addition, these companies, like all others in the industry, are vulnerable to catastrophe losses that could exceed their reinsurance protection and take their cost of float right off the chart. Unless these companies can materially improve their underwriting performance — and history indicates that is an almost impossible task — their shareholders will experience results similar to those borne by the owners of a bank that pays a higher rate of interest on deposits than it receives on loans.

All in all, the insurance business has treated us very well. We have expanded our float at a cost that on the average is reasonable, and we have further prospered because we have earned good returns on these low-cost funds. Our shareholders, true, have incurred extra taxes, but they have been more than compensated for this cost (so far) by the benefits produced by the float.

A particularly encouraging point about our record is that it was achieved despite some colossal mistakes made by your Chairman prior to Mike Goldberg's arrival. Insurance offers a host of opportunities for error, and when opportunity knocked, too often I answered. Many years later, the bills keep arriving for these mistakes: In the insurance business, there is no statute of limitations on stupidity.

The intrinsic value of our insurance business will always be far more difficult to calculate than the value of, say, our candy or newspaper companies. By any measure, however, the business is worth far more than its carrying value. Furthermore, despite the problems this operation periodically hands us, it is the one — among all the fine businesses we own — that has the greatest potential.

Marketable Securities

Below we list our common stock holdings having a value of over $100 million. A small portion of these investments belongs to subsidiaries of which Berkshire owns less than 100%.

Shares	*Company*	*Cost*	*12/31/90 Market*
		(000s omitted)	
3,000,000	Capital Cities/ABC, Inc.	$ 517,500	$1,377,375
46,700,000	The Coca-Cola Co.	1,023,920	2,171,550
2,400,000	Federal Home Loan Mortgage Corp.	71,729	117,000
6,850,000	GEICO Corp.	45,713	1,110,556
1,727,765	The Washington Post Company	9,731	342,097
5,000,000	Wells Fargo & Company	289,431	289,375

Lethargy bordering on sloth remains the cornerstone of our investment style: This year we neither bought nor sold a share of five of our six major holdings. The exception was Wells Fargo, a superbly-managed, high-return banking operation in which we increased our ownership to just under 10%, the most we can own without the approval of the Federal Reserve Board. About one-sixth of our position was bought in 1989, the rest in 1990.

The banking business is no favorite of ours. When assets are twenty times equity — a common ratio in this industry — mistakes that involve only a small portion of assets can destroy a major portion of equity.

And mistakes have been the rule rather than the exception at many major banks. Most have resulted from a managerial failing that we described last year when discussing the "institutional imperative:" the tendency of executives to mindlessly imitate the behavior of their peers, no matter how foolish it may be to do so. In their lending, many bankers played follow-the-leader with lemming-like zeal; now they are experiencing a lemming-like fate.

Because leverage of 20:1 magnifies the effects of managerial strengths and weaknesses, we have no interest in purchasing shares of a poorly-managed bank at a "cheap" price. Instead, our only interest is in buying into well-managed banks at fair prices.

With Wells Fargo, we think we have obtained the best managers in the business, Carl Reichardt and Paul Hazen. In many ways the combination of Carl and Paul reminds me of another — Tom Murphy and Dan Burke at Capital Cities/ABC. First, each pair is stronger than the sum of its parts because each partner understands, trusts and admires the other. Second, both managerial teams pay able people well, but abhor having a bigger head count than is needed. Third, both attack costs as vigorously when profits are at record levels as when they are under pressure. Finally, both stick with what they understand and let their abilities, not their egos, determine what they attempt. (Thomas J. Watson Sr. of IBM followed the same rule: "I'm no genius," he said. "I'm smart in spots — but I stay around those spots.")

Our purchases of Wells Fargo in 1990 were helped by a chaotic market in bank stocks. The disarray was appropriate: Month by month the foolish loan decisions of once well-regarded banks were put on public display. As one huge loss after another was unveiled — often on the heels of managerial assurances that all was well — investors understandably concluded that no bank's numbers were to be trusted. Aided by their flight from bank stocks, we purchased our 10% interest in Wells Fargo for $290 million, less than five times after-tax earnings, and less than three times pre-tax earnings.

Wells Fargo is big — it has $56 billion in assets — and has been earning more than 20% on equity and 1.25% on assets. Our purchase of one-tenth of the bank may be thought of as roughly equivalent to our buying 100% of a $5 billion bank with identical financial characteristics. But were we to make such a purchase, we would have to pay about twice the $290 million we paid for Wells Fargo. Moreover, that $5 billion bank, commanding a premium price, would present us with another problem: We would not be able to find a Carl Reichardt to run it. In recent years, Wells Fargo executives have been more avidly recruited than any others in the banking business; no one, however, has been able to hire the dean.

Of course, ownership of a bank — or about any other business — is far from riskless. California banks face the specific risk of a major earthquake, which might wreak enough havoc on borrowers to in turn destroy the banks lending to them. A second risk is systemic — the possibility of a business contraction or financial panic so severe that it would endanger almost every highly-leveraged institution, no matter how intelligently run. Finally, the market's major fear of the moment is that West Coast real estate values will tumble because of overbuilding and deliver huge losses to banks that have financed the expansion. Because it is a leading real estate lender, Wells Fargo is thought to be particularly vulnerable.

None of these eventualities can be ruled out. The probability of the first two occurring, however, is low and even a meaningful drop in real estate values is unlikely to cause major problems for well-managed institutions. Consider some mathematics: Wells Fargo currently earns well over $1 billion pre-tax annually after expensing more than $300 million for loan losses. If 10% of all $48 billion of the bank's loans — not just its real estate loans — were hit by problems in 1991, and these produced losses (including foregone interest) averaging 30% of principal, the company would roughly break even.

A year like that — which we consider only a low-level possibility, not a likelihood — would not distress us. In fact, at Berkshire we would love to acquire businesses or invest in capital projects that produced no return for a year, but that could then be expected to earn 20% on growing equity. Nevertheless, fears of a California real estate disaster similar to that experienced in New England caused the price of Wells Fargo stock to fall almost 50% within a few months during 1990. Even though we had bought some shares at the prices prevailing before the fall, we welcomed the decline because it allowed us to pick up many more shares at the new, panic prices.

Investors who expect to be ongoing buyers of investments throughout their lifetimes should adopt a similar attitude toward market fluctuations; instead many illogically become euphoric when stock prices

rise and unhappy when they fall. They show no such confusion in their reaction to food prices: Knowing they are forever going to be buyers of food, they welcome falling prices and deplore price increases. (It's the seller of food who doesn't like declining prices.) Similarly, at the Buffalo News we would cheer lower prices for newsprint — even though it would mean marking down the value of the large inventory of newsprint we always keep on hand — because we know we are going to be perpetually buying the product.

Identical reasoning guides our thinking about Berkshire's investments. We will be buying businesses — or small parts of businesses, called stocks — year in, year out as long as I live (and longer, if Berkshire's directors attend the seances I have scheduled). Given these intentions, declining prices for businesses benefit us, and rising prices hurt us.

The most common cause of low prices is pessimism — some times pervasive, some times specific to a company or industry. We *want* to do business in such an environment, not because we like pessimism but because we like the prices it produces. It's optimism that is the enemy of the rational buyer.

None of this means, however, that a business or stock is an intelligent purchase simply because it is unpopular; a contrarian approach is just as foolish as a follow-the-crowd strategy. What's required is thinking rather than polling. Unfortunately, Bertrand Russell's observation about life in general applies with unusual force in the financial world: "Most men would rather die than think. Many do."

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Our other major portfolio change last year was large additions to our holdings of RJR Nabisco bonds, securities that we first bought in late 1989. At yearend 1990 we had $440 million invested in these securities, an amount that approximated market value. (As I write this, however, their market value has risen by more than $150 million.)

Just as buying into the banking business is unusual for us, so is the purchase of below-investment-grade bonds. But opportunities that interest us and that are also large enough to have a worthwhile impact on Berkshire's results are rare. Therefore, we will look at any category of investment, so long as we understand the business we're buying into and believe that price and value may differ significantly. (Woody Allen, in another context, pointed out the advantage of open-mindedness: "I can't understand why more people aren't bi-sexual because it doubles your chances for a date on Saturday night.")

In the past we have bought a few below-investment-grade bonds with success, though these were all old-fashioned "fallen angels" — bonds that were initially of investment grade but that were downgraded when the issuers fell on bad times. In the 1984 annual report we described our rationale for buying one fallen angel, the Washington Public Power Supply System.

A kind of bastardized fallen angel burst onto the investment scene in the 1980s — "junk bonds" that were far below investment-grade when issued. As the decade progressed, new offerings of manufactured junk became ever junkier and ultimately the predictable outcome occurred: Junk bonds lived up to their name. In 1990 — even before the recession dealt its blows — the financial sky became dark with the bodies of failing corporations.

The disciples of debt assured us that this collapse wouldn't happen: Huge debt, we were told, would cause operating managers to focus their efforts as never before, much as a dagger mounted on the steering wheel of a car could be expected to make its driver proceed with intensified care. We'll acknowledge that such an attention-getter would produce a very alert driver. But another certain consequence would be a deadly — and unnecessary — accident if the car hit even the tiniest pothole or sliver of ice. The roads of business are riddled with potholes; a plan that requires dodging them all is a plan for disaster.

In the final chapter of The Intelligent Investor Ben Graham forcefully rejected the dagger thesis: "Confronted with a challenge to distill the secret of sound investment into three words, we venture the motto, Margin of Safety." Forty-two years after reading that, I still think those are the right three words. The failure of investors to heed this simple message caused them staggering losses as the 1990s began.

At the height of the debt mania, capital structures were concocted that guaranteed failure: In some cases, so much debt was issued that even highly favorable business results could not produce the funds to service it. One particularly egregious "kill-'em-at-birth" case a few years back involved the purchase of

a mature television station in Tampa, bought with so much debt that the interest on it exceeded the station's *gross revenues*. Even if you assume that all labor, programs and services were donated rather than purchased, this capital structure required revenues to explode — or else the station was doomed to go broke. (Many of the bonds that financed the purchase were sold to now-failed savings and loan associations; as a taxpayer, you are picking up the tab for this folly.)

All of this seems impossible now. When these misdeeds were done, however, dagger-selling investment bankers pointed to the "scholarly" research of academics, which reported that over the years the higher interest rates received from low-grade bonds had more than compensated for their higher rate of default. Thus, said the friendly salesmen, a diversified portfolio of junk bonds would produce greater net returns than would a portfolio of high-grade bonds. (Beware of past-performance "proofs" in finance: If history books were the key to riches, the Forbes 400 would consist of librarians.)

There was a flaw in the salesmen's logic — one that a first-year student in statistics is taught to recognize. An assumption was being made that the universe of newly-minted junk bonds was identical to the universe of low-grade fallen angels and that, therefore, the default experience of the latter group was meaningful in predicting the default experience of the new issues. (That was an error similar to checking the historical death rate from Kool-Aid before drinking the version served at Jonestown.)

The universes were of course dissimilar in several vital respects. For openers, the manager of a fallen angel almost invariably yearned to regain investment-grade status and worked toward that goal. The junk-bond operator was usually an entirely different breed. Behaving much as a heroin user might, he devoted his energies not to finding a cure for his debt-ridden condition, but rather to finding another fix. Additionally, the fiduciary sensitivities of the executives managing the typical fallen angel were often, though not always, more finely developed than were those of the junk-bond-issuing financiopath.

Wall Street cared little for such distinctions. As usual, the Street's enthusiasm for an idea was proportional not to its merit, but rather to the revenue it would produce. Mountains of junk bonds were sold by those who didn't care to those who didn't think — and there was no shortage of either.

Junk bonds remain a mine field, even at prices that today are often a small fraction of issue price. As we said last year, we have never bought a new issue of a junk bond. (The only time to buy these is on a day with no "y" in it.) We are, however, willing to look at the field, now that it is in disarray.

In the case of RJR Nabisco, we feel the Company's credit is considerably better than was generally perceived for a while and that the yield we receive, as well as the potential for capital gain, more than compensates for the risk we incur (though that is far from nil). RJR has made asset sales at favorable prices, has added major amounts of equity, and in general is being run well.

However, as we survey the field, most low-grade bonds still look unattractive. The handiwork of the Wall Street of the 1980s is even worse than we had thought: Many important businesses have been mortally wounded. We will, though, keep looking for opportunities as the junk market continues to unravel.

Convertible Preferred Stocks

We continue to hold the convertible preferred stocks described in earlier reports: $700 million of Salomon Inc, $600 million of The Gillette Company, $358 million of USAir Group, Inc. and $300 million of Champion International Corp. Our Gillette holdings will be converted into 12 million shares of common stock on April 1. Weighing interest rates, credit quality and prices of the related common stocks, we can assess our holdings in Salomon and Champion at yearend 1990 as worth about what we paid, Gillette as worth somewhat more, and USAir as worth substantially less.

In making the USAir purchase, your Chairman displayed exquisite timing: I plunged into the business at almost the exact moment that it ran into severe problems. (No one pushed me; in tennis parlance, I committed an "unforced error.") The company's troubles were brought on both by industry conditions and by the post-merger difficulties it encountered in integrating Piedmont, an affliction I should have expected since almost all airline mergers have been followed by operational turmoil.

In short order, Ed Colodny and Seth Schofield resolved the second problem: The airline now gets excellent marks for service. Industry-wide problems have proved to be far more serious. Since our purchase, the economics of the airline industry have deteriorated at an alarming pace, accelerated by the kamikaze pricing tactics of certain carriers. The trouble this pricing has produced for all carriers illustrates an important truth: In a business selling a commodity-type product, it's impossible to be a lot smarter than your dumbest competitor.

However, unless the industry is decimated during the next few years, our USAir investment should work out all right. Ed and Seth have decisively addressed the current turbulence by making major changes in operations. Even so, our investment is now less secure than at the time I made it.

Our convertible preferred stocks are relatively simple securities, yet I should warn you that, if the past is any guide, you may from time to time read inaccurate or misleading statements about them. Last year, for example, several members of the press calculated the value of all our preferreds as equal to that of the common stock into which they are convertible. By their logic, that is, our Salomon preferred, convertible into common at $38, would be worth 60% of face value if Salomon common were selling at $22.80. But there is a small problem with this line of reasoning: Using it, one must conclude that all of the value of a convertible preferred resides in the conversion privilege and that the value of a *non*-convertible preferred of Salomon would be zero, no matter what its coupon or terms for redemption.

The point you should keep in mind is that most of the value of our convertible preferreds is derived from their fixed-income characteristics. That means the securities cannot be worth less than the value they would possess as non-convertible preferreds and may be worth more because of their conversion options.

* * * * * * * * * * * *

I deeply regret having to end this section of the report with a note about my friend, Colman Mockler, Jr., CEO of Gillette, who died in January. No description better fitted Colman than "gentleman" — a word signifying integrity, courage and modesty. Couple these qualities with the humor and exceptional business ability that Colman possessed and you can understand why I thought it an undiluted pleasure to work with him and why I, and all others who knew him, will miss Colman so much.

A few days before Colman died, Gillette was richly praised in a Forbes cover story. Its theme was simple: The company's success in shaving products has come not from marketing savvy (though it exhibits that talent repeatedly) but has instead resulted from its devotion to quality. This mind-set has caused it to consistently focus its energies on coming up with something better, even though its existing products already ranked as the class of the field. In so depicting Gillette, Forbes in fact painted a portrait of Colman.

Help! Help!

Regular readers know that I shamelessly utilize the annual letter in an attempt to acquire businesses for Berkshire. And, as we constantly preach at the Buffalo News, advertising does work: Several businesses have knocked on our door because someone has read in these pages of our interest in making acquisitions. (Any good ad salesman will tell you that trying to sell something without advertising is like winking at a girl in the dark.)

In Appendix B (on pages 26 - 27) I've reproduced the essence of a letter I wrote a few years back to the owner/manager of a desirable business. If you have no personal connection with a business that might be of interest to us but have a friend who does, perhaps you can pass this report along to him.

Here's the sort of business we are 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. At the same time, these managers 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 such objectives. We 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. A line from a country song expresses our feeling about new ventures, turnarounds, or auction-like sales: "When the phone don't ring, you'll know it's me."

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 Capital Cities, Salomon, Gillette, USAir, and Champion. We are not interested, however, in receiving suggestions about purchases we might make in the general stock market.

Miscellaneous

Ken Chace has decided not to stand for reelection as a director at our upcoming annual meeting. We have no mandatory retirement age for directors at Berkshire (and won't!), but Ken, at 75 and living in Maine, simply decided to cut back his activities.

Ken was my immediate choice to run the textile operation after Buffett Partnership, Ltd. assumed control of Berkshire early in 1965. Although I made an economic mistake in sticking with the textile business, I made no mistake in choosing Ken: He ran the operation well, he was always 100% straight with me about its problems, and he generated the funds that allowed us to diversify into insurance.

My wife, Susan, will be nominated to succeed Ken. She is now the second largest shareholder of Berkshire and if she outlives me will inherit all of my stock and, effectively, control the company. She knows, and agrees, with my thoughts on successor management and also shares my view that neither Berkshire nor its subsidiary businesses and important investments should be sold simply because some very high bid is received for one or all.

I feel strongly that the fate of our businesses and their managers should not depend on my health — which, it should be added, is excellent — and I have planned accordingly. Neither my estate plan nor that of my wife is designed to preserve the family fortune; instead, both are aimed at preserving the character of Berkshire and returning the fortune to society.

Were I to die tomorrow, you could be sure of three things: (1) None of my stock would have to be sold; (2) Both a controlling shareholder and a manager with philosophies similar to mine would follow me; and (3) Berkshire's earnings would increase by $1 million annually, since Charlie would immediately sell our corporate jet, The Indefensible (ignoring my wish that it be buried with me).

* * * * * * * * * * * *

About 97.3% of all eligible shares participated in Berkshire's 1990 shareholder-designated contributions program. Contributions made through the program were $5.8 million, and 2,600 charities were recipients.

We suggest that new shareholders read the description of our shareholder-designated contributions program that appears on pages 54 - 55. To participate in future programs, you must 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 August 31, 1991 will be ineligible for the 1991 program.

In addition to the shareholder-designated contributions that Berkshire distributes, managers of our operating businesses make contributions, including merchandise, averaging about $1.5 million annually. These contributions support local charities, such as The United Way, and produce roughly commensurate benefits for our businesses.

However, neither our operating managers nor officers of the parent company use Berkshire funds to make contributions to broad national programs or charitable activities of special personal interest to them, except to the extent they do so as shareholders. If your employees, including your CEO, wish to give to their alma maters or other institutions to which they feel a personal attachment, we believe they should use their own money, not yours.

* * * * * * * * * * * *

The annual meeting this year will be held at the Orpheum Theater in downtown Omaha at 9:30 a.m. on Monday, April 29, 1991. Attendance last year grew to a record 1,300, about a 100-fold increase from ten years ago.

We recommend getting your hotel reservations early at one of these hotels: (1) The Radisson-Redick Tower, a small (88 rooms) but nice hotel across the street from the Orpheum; (2) the much larger Red Lion Hotel, located about a five-minute walk from the Orpheum; or (3) the Marriott, located in West Omaha about 100 yards from Borsheim's and a twenty minute drive from downtown. We will have buses at the Marriott that will leave at 8:30 and 8:45 for the meeting, and return after it ends.

Charlie and I always enjoy the meeting, and we hope you can make it. The quality of our shareholders is reflected in the quality of the questions we get: We have never attended an annual meeting anywhere that features such a consistently high level of intelligent, owner-related questions.

An attachment to our proxy material explains how you can obtain the card you will need for admission to the meeting. Because weekday parking can be tight around the Orpheum, we have lined up a number of nearby lots for our shareholders to use. The attachment also contains information about them.

As usual, we will have buses to take you to Nebraska Furniture Mart and Borsheim's after the meeting and to take you to downtown hotels or to the airport later. I hope that you will allow plenty of time to fully explore the attractions of both stores. Those of you arriving early can visit the Furniture Mart any day of the week; it is open from 10 a.m. to 5:30 p.m. on Saturdays, and from noon to 5:30 p.m. on Sundays. While there, stop at the See's Candy cart and see for yourself the dawn of synergism at Berkshire.

Borsheim's normally is closed on Sunday, but we will open for shareholders and their guests from noon to 6 p.m. on Sunday, April 28. At our Sunday opening last year you made Ike very happy: After totaling the day's volume, he suggested to me that we start holding annual meetings quarterly. Join us at Borsheim's even if you just come to watch; it's a show you shouldn't miss.

Last year the first question at the annual meeting was asked by 11-year-old Nicholas Kenner, a third-generation shareholder from New York City. Nicholas plays rough: "How come the stock is down?" he fired at me. My answer was not memorable.

We hope that other business engagements won't keep Nicholas away from this year's meeting. If he attends, he will be offered the chance to again ask the first question; Charlie and I want to tackle him while we're *fresh*. This year, however, it's Charlie's turn to answer.

Warren E. Buffett
Chairman of the Board

March 1, 1991

U. S. STEEL ANNOUNCES SWEEPING MODERNIZATION SCHEME*

Myron C. Taylor, Chairman of U. S. Steel Corporation, today announced the long awaited plan for completely modernizing the world's largest industrial enterprise. Contrary to expectations, no changes will be made in the company's manufacturing or selling policies. Instead, the bookkeeping system is to be entirely revamped. By adopting and further improving a number of modern accounting and financial devices the corporation's earning power will be amazingly transformed. Even under the subnormal conditions of 1935, it is estimated that the new bookkeeping methods would have yielded a reported profit of close to $50 per share on the common stock. The scheme of improvement is the result of a comprehensive survey made by Messrs. Price, Bacon, Guthrie & Colpitts; it includes the following six points:

1. Writing down of Plant Account to Minus $1,000,000,000.
2. Par value of common stock to be reduced to 1¢.
3. Payment of all wages and salaries in option warrants.
4. Inventories to be carried at $1.
5. Preferred Stock to be replaced by non-interest bearing bonds redeemable at 50% discount.
6. A $1,000,000,000 Contingency Reserve to be established.

The official statement of this extraordinary Modernization Plan follows in full:

The Board of Directors of U. S. Steel Corporation is pleased to announce that after intensive study of the problems arising from changed conditions in the industry, it has approved a comprehensive plan for remodeling the Corporation's accounting methods. A survey by a Special Committee, aided and abetted by Messrs. Price, Bacon, Guthrie & Colpitts, revealed that our company has lagged somewhat behind other American business enterprises in utilizing certain advanced bookkeeping methods, by means of which the earning power may be phenomenally enhanced without requiring any cash outlay or any changes in operating or sales conditions. It has been decided not only to adopt these newer methods, but to develop them to a still higher stage of perfection. The changes adopted by the Board may be summarized under six heads, as follows:

1. Fixed Assets to be written down to Minus $1,000,000,000.

Many representative companies have relieved their income accounts of all charges for depreciation by writing down their plant account to $1. The Special Committee points out that if their plants are worth only $1, the fixed assets of U. S. Steel Corporation are worth a good deal less than that sum. It is now a well-recognized fact that many plants are in reality a liability rather than an asset, entailing not only depreciation charges, but taxes, maintenance, and other expenditures. Accordingly, the Board has decided to extend the write-down policy initiated in the 1935 report, and to mark down the Fixed Assets from $1,338,522,858.96 to a round Minus $1,000,000,000.

The advantages of this move should be evident. As the plant wears out, the liability becomes correspondingly reduced. Hence, instead of the present depreciation charge of some $47,000,000 yearly there will be an annual appreciation credit of 5%, or $50,000,000. This will increase earnings by no less than $97,000,000 per annum.

2. Reduction of Par Value of Common Stock to 1¢, and
3. Payment of Salaries and Wages in Option Warrants.

* An unpublished satire by Ben Graham, written in 1936 and given by the author to Warren Buffett in 1954.

Many corporations have been able to reduce their overhead expenses substantially by paying a large part of their executive salaries in the form of options to buy stock, which carry no charge against earnings. The full possibilities of this modern device have apparently not been adequately realized. The Board of Directors have adopted the following advanced form of this idea:

The entire personnel of the Corporation are to receive their compensation in the form of rights to buy common stock at $50 per share, at the rate of one purchase right for each $50 of salary and/or wages in their present amounts. The par value of the common stock is to be reduced to 1¢.

The almost incredible advantages of this new plan are evident from the following:

A. The payroll of the Corporation will be entirely eliminated, a saving of $250,000,000 per annum, based on 1935 operations.

B. At the same time, the effective compensation of all our employees will be increased severalfold. Because of the large earnings per share to be shown on our common stock under the new methods, it is certain that the shares will command a price in the market far above the option level of $50 per share, making the readily realizable value of these option warrants greatly in excess of the present cash wages that they will replace.

C. The Corporation will realize an additional large annual profit through the exercise of these warrants. Since the par value of the common stock will be fixed at 1¢, there will be a gain of $49.99 on each share subscribed for. In the interest of conservative accounting, however, this profit will not be included in the income account, but will be shown separately as a credit to Capital Surplus.

D. The Corporation's cash position will be enormously strengthened. In place of the present annual cash outgo of $250,000,000 for wages (1935 basis), there will be annual cash inflow of $250,000,000 through exercise of the subscription warrants for 5,000,000 shares of common stock. The Company's large earnings and strong cash position will permit the payment of a liberal dividend which, in turn, will result in the exercise of these option warrants immediately after issuance which, in turn, will further improve the cash position which, in turn, will permit a higher dividend rate — and so on, indefinitely.

4. Inventories to be carried at $1.

Serious losses have been taken during the depression due to the necessity of adjusting inventory value to market. Various enterprises — notably in the metal and cotton-textile fields — have successfully dealt with this problem by carrying all or part of their inventories at extremely low unit prices. The U. S. Steel Corporation has decided to adopt a still more progressive policy, and to carry its entire inventory at $1. This will be effected by an appropriate write-down at the end of each year, the amount of said write-down to be charged to the Contingency Reserve hereinafter referred to.

The benefits to be derived from this new method are very great. Not only will it obviate all possibility of inventory depreciation, but it will substantially enhance the annual earnings of the Corporation. The inventory on hand at the beginning of the year, valued at $1, will be sold during the year at an excellent profit. It is estimated that our income will be increased by means of this method to the extent of at least $150,000,000 per annum which, by a coincidence, will about equal the amount of the write-down to be made each year against Contingency Reserve.

A minority report of the Special Committee recommends that Accounts Receivable and Cash also be written down to $1, in the interest of consistency and to gain additional advantages similar to those just discussed. This proposal has been rejected for the time being because our auditors still require that any recoveries of receivables and cash so charged off be credited to surplus instead of to the year's income. It is expected, however, that this auditing rule — which is rather reminiscent of the horse-and-buggy days — will soon be changed in line with modern tendencies. Should this occur, the minority report will be given further and favorable consideration.

5. Replacement of Preferred Stock by Non-Interest Bearing Bonds Redeemable at 50% Discount.

During the recent depression many companies have been able to offset their operating losses by including in income profits arising from repurchases of their own bonds at a substantial discount from par. Unfortunately the credit of U. S. Steel Corporation has always stood so high that this lucrative source of revenue has not hitherto been available to it. The Modernization Scheme will remedy this condition.

It is proposed that each share of preferred stock be exchanged for $300 face value of non-interest-bearing sinking-fund notes, redeemable by lot at 50% of face value in 10 equal annual installments. This will require the issuance of $1,080,000,000 of new notes, of which $108,000,000 will be retired each year at a cost to the Corporation of only $54,000,000, thus creating an annual profit of the same amount.

Like the wage-and/or-salary plan described under 3. above, this arrangement will benefit both the Corporation and its preferred stockholders. The latter are assured payment for their present shares at 150% of par value over an average period of five years. Since short-term securities yield practically no return at present, the non-interest-bearing feature is of no real importance. The Corporation will convert its present annual charge of $25,000,000 for preferred dividends into an annual bond-retirement profit of $54,000,000 — an aggregate yearly gain of $79,000,000.

6. Establishment of a Contingency Reserve of $1,000,000,000.

The Directors are confident that the improvements hereinbefore described will assure the Corporation of a satisfactory earning power under all conditions in the future. Under modern accounting methods, however, it is unnecessary to incur the slightest risk of loss through adverse business developments of any sort, since all these may be provided for in advance by means of a Contingency Reserve.

The Special Committee has recommended that the Corporation create such a Contingency Reserve in the fairly substantial amount of $1,000,000,000. As previously set forth, the annual write-down of inventory to $1 will be absorbed by this reserve. To prevent eventual exhaustion of the Contingency Reserve, it has been further decided that it be replenished each year by transfer of an appropriate sum from Capital Surplus. Since the latter is expected to increase each year by not less than $250,000,000 through the exercise of the Stock Option Warrants (see 3. above), it will readily make good any drains on the Contingency Reserve.

In setting up this arrangement, the Board of Directors must confess regretfully that they have been unable to improve upon the devices already employed by important corporations in transferring large sums between Capital, Capital Surplus, Contingency Reserves and other Balance Sheet Accounts. In fact, it must be admitted that our entries will be somewhat too simple, and will lack that element of extreme mystification that characterizes the most advanced procedure in this field. The Board of Directors, however, have insisted upon clarity and simplicity in framing their Modernization Plan, even at the sacrifice of possible advantage to the Corporation's earning power.

In order to show the combined effect of the new proposals upon the Corporation's earning power, we submit herewith a condensed Income Account for 1935 on two bases, viz:

	A. As Reported	B. Pro-Forma Giving Effect to Changes Proposed Herewith
Gross Receipts from all Sources (Including Inter-Company)	$765,000,000	$765,000,000
Salaries and Wages	251,000,000	—
Other Operating Expenses and Taxes	461,000,000	311,000,000
Depreciation	47,000,000	(50,000,000)
Interest	5,000,000	5,000,000
Discount on Bonds Retired	—	(54,000,000)
Preferred Dividends	25,000,000	—
Balance for Common	(24,000,000)	553,000,000
Average Shares Outstanding	8,703,252	11,203,252
Earned Per Share	($2.76)	$49.80

In accordance with a somewhat antiquated custom there is appended herewith a condensed pro-forma Balance Sheet of the U. S. Steel Corporation as of December 31, 1935, after giving effect to proposed changes in asset and liability accounts.

ASSETS

Fixed Assets, net	($1,000,000,000)
Cash Assets	142,000,000
Receivables	56,000,000
Inventory	1
Miscellaneous Assets	27,000,000
Total	($774,999,999)

LIABILITIES

Common Stock Par 1¢ (Par Value $87,032.52) Stated Value*	($3,500,000,000)
Subsidiaries' Bonds and Stocks	113,000,000
New Sinking Fund Notes	1,080,000,000
Current Liabilities	69,000,000
Contingency Reserve	1,000,000,000
Other Reserves	74,000,000
Initial Surplus	389,000,001
Total	($774,999,999)

*Given a Stated Value differing from Par Value, in accordance with the laws of the State of Virginia, where the company will be re-incorporated.

It is perhaps unnecessary to point out to our stockholders that modern accounting methods give rise to balance sheets differing somewhat in appearance from those of a less advanced period. In view of the very large earning power that will result from these changes in the Corporation's Balance Sheet, it is not expected that undue attention will be paid to the details of assets and liabilities.

In conclusion, the Board desires to point out that the combined procedure, whereby plant will be carried at a minus figure, our wage bill will be eliminated, and inventory will stand on our books at virtually nothing, will give U. S. Steel Corporation an enormous competitive advantage in the industry. We shall be able to sell our products at exceedingly low prices and still show a handsome margin of profit. It is the considered view of the Board of Directors that under the Modernization Scheme we shall be able to undersell all competitors to such a point that the anti-trust laws will constitute the only barrier to 100% domination of the industry.

In making this statement, the Board is not unmindful of the possibility that some of our competitors may seek to offset our new advantages by adopting similar accounting improvements. We are confident, however, that U. S. Steel will be able to retain the loyalty of its customers, old and new, through the unique prestige that will accrue to it as the originator and pioneer in these new fields of service to the user of steel. Should necessity arise, moreover, we believe we shall be able to maintain our deserved superiority by introducing still more advanced bookkeeping methods, which are even now under development in our Experimental Accounting Laboratory.

Some Thoughts on Selling Your Business*

Dear _____________:

Here are a few thoughts pursuant to our conversation of the other day.

Most business owners spend the better part of their lifetimes building their businesses. By experience built upon endless repetition, they sharpen their skills in merchandising, purchasing, personnel selection, etc. It's a learning process, and mistakes made in one year often contribute to competence and success in succeeding years.

In contrast, owner-managers sell their business only once — frequently in an emotionally-charged atmosphere with a multitude of pressures coming from different directions. Often, much of the pressure comes from brokers whose compensation is contingent upon consummation of a sale, regardless of its consequences for both buyer and seller. The fact that the decision is so important, both financially and personally, to the owner can make the process more, rather than less, prone to error. And, mistakes made in the once-in-a-lifetime sale of a business are not reversible.

Price is very important, but often is not the most critical aspect of the sale. You and your family have an extraordinary business — one of a kind in your field — and any buyer is going to recognize that. It's also a business that is going to get more valuable as the years go by. So if you decide not to sell now, you are very likely to realize more money later on. With that knowledge you can deal from strength and take the time required to select the buyer you want.

If you should decide to sell, I think Berkshire Hathaway offers some advantages that most other buyers do not. Practically all of these buyers will fall into one of two categories:

(1) A company located elsewhere but operating in your business or in a business somewhat akin to yours. Such a buyer — no matter what promises are made — will usually have managers who feel they know how to run your business operations and, sooner or later, will want to apply some hands-on "help." If the acquiring company is much larger, it often will have squads of managers, recruited over the years in part by promises that they will get to run future acquisitions. They will have their own way of doing things and, even though your business record undoubtedly will be far better than theirs, human nature will at some point cause them to believe that their methods of operating are superior. You and your family probably have friends who have sold their businesses to larger companies, and I suspect that their experiences will confirm the tendency of parent companies to take over the running of their subsidiaries, particularly when the parent knows the industry, or thinks it does.

(2) A financial maneuverer, invariably operating with large amounts of borrowed money, who plans to resell either to the public or to another corporation as soon as the time is favorable. Frequently, this buyer's major contribution will be to change accounting methods so that earnings can be presented in the most favorable light just prior to his bailing out. I'm enclosing a recent article that describes this sort of transaction, which is becoming much more frequent because of a rising stock market and the great supply of funds available for such transactions.

If the sole motive of the present owners is to cash their chips and put the business behind them — and plenty of sellers fall in this category — either type of buyer that I've just described is satisfactory. But if the sellers' business represents the creative work of a lifetime and forms an integral part of their personality and sense of being, buyers of either type have serious flaws.

Berkshire is another kind of buyer — a rather unusual one. We buy to keep, but we don't have, and don't expect to have, operating people in our parent organization. All of the businesses we own are run

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* This is an edited version of a letter I sent some years ago to a man who had indicated that he might want to sell his family business. I present it here because it is a message I would like to convey to other prospective sellers. — W.E.B.

autonomously to an extraordinary degree. In most cases, the managers of important businesses we have owned for many years have not been to Omaha or even met each other. When we buy a business, the sellers go on running it just as they did before the sale; we adapt to their methods rather than vice versa.

We have no one — family, recently recruited MBAs, etc. — to whom we have promised a chance to run businesses we have bought from owner-managers. And we won't have.

You know of some of our past purchases. I'm enclosing a list of everyone from whom we have ever bought a business, and I invite you to check with them as to our performance versus our promises. You should be particularly interested in checking with the few whose businesses did not do well in order to ascertain how we behaved under difficult conditions.

Any buyer will tell you that he needs you personally — and if he has any brains, he most certainly does need you. But a great many buyers, for the reasons mentioned above, don't match their subsequent actions to their earlier words. We will behave exactly as promised, both because we have so promised, and because we need to in order to achieve the best business results.

This need explains why we would want the operating members of your family to retain a 20% interest in the business. We need 80% to consolidate earnings for tax purposes, which is a step important to us. It is equally important to us that the family members who run the business remain as owners. Very simply, we would not want to buy unless we felt key members of present management would stay on as our partners. Contracts cannot guarantee your continued interest; we would simply rely on your word.

The areas I get involved in are capital allocation and selection and compensation of the top man. Other personnel decisions, operating strategies, etc. are his bailiwick. Some Berkshire managers talk over some of their decisions with me; some don't. It depends upon their personalities and, to an extent, upon their own personal relationship with me.

If you should decide to do business with Berkshire, we would pay in cash. Your business would not be used as collateral for any loan by Berkshire. There would be no brokers involved.

Furthermore, there would be no chance that a deal would be announced and that the buyer would then back off or start suggesting adjustments (with apologies, of course, and with an explanation that banks, lawyers, boards of directors, etc. were to be blamed). And finally, you would know exactly with whom you are dealing. You would not have one executive negotiate the deal only to have someone else in charge a few years later, or have the president regretfully tell you that his board of directors required this change or that (or possibly required sale of your business to finance some new interest of the parent's).

It's only fair to tell you that you would be no richer after the sale than now. The ownership of your business already makes you wealthy and soundly invested. A sale would change the form of your wealth, but it wouldn't change its amount. If you sell, you will have exchanged a 100%-owned valuable asset that you understand for another valuable asset — cash — that will probably be invested in small pieces (stocks) of other businesses that you understand less well. There is often a sound reason to sell but, if the transaction is a fair one, the reason is not so that the seller can become wealthier.

I will not pester you; if you have any possible interest in selling, I would appreciate your call. I would be extraordinarily proud to have Berkshire, along with the key members of your family, own __________; I believe we would do very well financially; and I believe you would have just as much fun running the business over the next 20 years as you have had during the past 20.

Sincerely,

/s/ Warren E. Buffett

BERKSHIRE HATHAWAY INC.
and Subsidiaries
CONSOLIDATED BALANCE SHEETS
(dollars in thousands except per share amounts)

	December 31, 1990	December 31, 1989
ASSETS		
Cash and cash equivalents	$ 247,024	$ 205,127
Investments:		
Obligations with fixed maturities	3,061,075	2,795,588
Marketable equity securities	5,685,983	5,261,598
Loans and accounts receivable	705,649	554,763
Inventories	203,795	195,927
Properties and equipment	209,870	207,432
Other assets	557,027	239,159
	$10,670,423	$9,459,594
LIABILITIES AND SHAREHOLDERS' EQUITY		
Losses and loss adjustment expenses	$ 2,050,305	$1,436,311
Unearned premiums	126,381	143,631
Savings accounts	286,093	291,592
Accounts payable, accruals and other liabilities	475,873	443,602
Income taxes	1,111,783	1,129,038
Term debt and other borrowings	1,239,358	1,007,516
	5,289,793	4,451,690
Minority shareholders' interests	93,176	82,778
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	2,310,433	2,342,198
Retained earnings	2,855,061	2,460,968
	5,329,747	4,967,419
Less common stock in treasury, at cost (228,761 shares)	42,293	42,293
Total shareholders' equity	5,287,454	4,925,126
	$10,670,423	$9,459,594

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,		
	1990	**1989**	**1988**
Revenues:			
Sales and service revenues	$1,580,074	$1,526,459	$1,407,642
Insurance premiums earned	591,540	394,279	584,235
Interest and dividend income	450,295	331,452	314,251
Realized investment gain	33,989	223,810	131,671
Sundry income	3,574	7,892	27,094
	2,659,472	2,483,892	2,464,893
Cost and expenses:			
Cost of products and services sold	871,073	844,056	753,845
Insurance losses and loss adjustment expenses	534,261	309,391	437,695
Insurance underwriting expenses	83,926	109,288	157,621
Selling, general and administrative expenses	541,054	526,359	495,331
Interest expense	112,692	77,574	70,280
	2,143,006	1,866,668	1,914,772
Earnings before income taxes	516,466	617,224	550,121
Income taxes	112,047	159,287	140,791
	404,419	457,937	409,330
Minority interest	10,326	10,460	10,060
Net earnings	$ 394,093	$ 447,477	$ 399,270
Net earnings per share	$344	$390	$348

See accompanying Notes to Consolidated Financial Statements

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

	Year Ended December 31,		
	1990	**1989**	**1988**
Cash flows from operating activities:			
Net income	$ 394,093	$ 447,477	$ 399,270
Adjustments to reconcile net income to cash flows from operating activities:			
Depreciation and amortization	34,083	32,107	29,808
Realized investment gain	(33,989)	(223,810)	(131,671)
Investment purchase price discount accretion less premium amortization	(58,648)	(3,663)	272
Amortization of issue discount on zero coupon notes	22,618	5,683	—
Minority interests	10,326	10,460	10,060
Increase in liability for losses and loss adjustment expenses	613,994	29,122	146,767
Increase in deferred charges re reinsurance assumed	(350,787)	—	—
Decrease in unearned premiums	(17,250)	(98,187)	(99,526)
(Increase) decrease in accounts receivable	(133,809)	8,923	8,699
Increase in accounts payable, accruals and other liabilities	32,271	118,088	45,426
Other	9,666	4,006	(45,224)
Net cash flows from operating activities	522,568	330,206	363,881
Cash flows from investing activities:			
Purchases of fixed maturity investments	(287,700)	(1,468,157)	(109,245)
Purchases of marketable equity securities	(729,352)	(739,932)	(1,708,971)
Proceeds from sales of fixed maturity investments	61,035	519,470	345,351
Proceeds from redemptions and maturities of fixed maturity investments	21,457	28,985	46,104
Proceeds from sales of marketable equity securities	261,923	821,656	878,228
Loans originated in finance businesses	(132,313)	(133,546)	(103,602)
Principal collection on loans	110,415	109,830	111,745
Other	11,762	(57,174)	21,144
Net cash flows from investing activities	(682,773)	(918,868)	(519,246)
Cash flows from financing activities:			
Proceeds from borrowings	785,818	1,172,356	250,000
Repayments of borrowings	(576,634)	(650,019)	(59,877)
Other	(7,082)	6,371	(1,639)
Net cash flows from financing activities	202,102	528,708	188,484
Increase (decrease) in cash and cash equivalents	41,897	(59,954)	33,119
Cash and cash equivalents at beginning of year	205,127	265,081	231,962
Cash and cash equivalents at end of year	$ 247,024	$ 205,127	$ 265,081
Other cash flow information:			
Income taxes paid	$ 113,860	$ 181,468	$ 137,148
Interest paid	79,857	70,191	61,798

See accompanying Notes to Consolidated Financial Statements

BERKSHIRE HATHAWAY INC.
and Subsidiaries
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 1990

(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. Intercompany accounts and transactions have been eliminated.

(b) *Cash equivalents*

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

(c) *Investments*

Investments in obligations with fixed maturities are carried at cost. Marketable equity securities held by members of the Berkshire Hathaway Insurance Group are carried at market value, marketable equity securities held by the Company and by non-insurance subsidiaries are carried at the lower of aggregate cost or market.

(d) *Cost of investments sold*

Cost of investments sold is usually determined on a first-in, first-out basis. Occasionally, when specific identification 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. The net unamortized balance is carried in other assets.

(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) *Deferred charges re reinsurance assumed*

The excess of estimated liabilities for claims and claim costs ultimately payable by the Insurance Group over consideration received with respect to retroactive property/casualty reinsurance contracts that provide for indemnification of insurance risk, other than structured settlements, is established as a deferred charge at inception of such contracts. The deferred charges are subsequently amortized using the interest method over the periods that the liabilities for the claims and claim costs are expected to be outstanding. At December 31, 1990, deferred charges re reinsurance assumed in the amount of $350,787,000 are included in other assets.

(h) *Losses and loss adjustment expense*

Liability for losses and loss adjustment expenses represents the aggregate of such obligations of members of the Insurance Group with respect to: (a) prospective property/casualty insurance and reinsurance contracts, (b) retroactive property/casualty reinsurance contracts that provide for indemnification of insurance risk, other than structured settlements, and (c) contracts providing for periodic payments with respect to settled claims ("structured settlements"). Except for structured settlement liabilities which are stated at discounted present values, the liability for losses and loss adjustment expenses is at the aggregate of estimated ultimate payment amounts less amounts recoverable on account of reinsurance.

Ultimate payment amounts with respect to prospective contracts are determined from (i) individual case estimates, (ii) estimates of incurred but not reported losses, based on past experience, and (iii) reports of losses from ceding insurers.

Notes to Consolidated Financial Statements *(Continued)*

(1) Significant accounting policies and practices *(Continued)*

(h) Losses and loss adjustment expense (continued)

Ultimate payment amounts with respect to retroactive reinsurance contracts that provide for indemnification of insurance risk, other than structured settlements, are established for financial reporting purposes at maximum limits of indemnification under the contracts. This liability amounted to $737,524,000 at December 31, 1990 of which $350,787,000 was established for financial reporting purposes as deferred charges re reinsurance. See also 1(g) above. For statutory reporting purposes, liabilities under these contracts are established, not at worst-case maximum loss limits, but at best estimates of claims and claim costs ultimately payable thereunder. These "best estimates" yielded as of December 31, 1990 a liability of $425,595,000. Also for statutory reporting purposes, a 1990 underwriting loss of approximately $68 million resulted from the contracts. For financial reporting purposes, underwriting gain or loss from the contracts for 1990 was zero. For Federal income tax reporting purposes, the liabilities as established for statutory reporting purposes are subjected to discounting, and 1990 taxable income of approximately $1.3 million, resulted from the contracts.

Liabilities under structured settlement contracts are established on a contract-by-contract basis when the contracts are entered into, at the then present value of the actuarially determined ultimate payment amount discounted at the market interest rate. Thereafter, annual accretions to the liabilities are charged to losses incurred. The aggregate of these liabilities for financial reporting purposes at December 31, 1990 was $264,718,000. For statutory and tax reporting purposes, where the liabilities are determined using discount rates mandated by Insurance Regulatory authorities (5% for contracts incepting after 1986 and 7% with respect to contracts dated prior to 1987), the aggregate of structured settlement liabilities was $353,613,000.

(j) Insurance premiums

Insurance premiums for prospective insurance and reinsurance policies are recognized as revenues ratably over their terms. Related unearned premiums are computed on a monthly or daily pro rata basis and are stated after deduction of unearned premiums ceded to reinsurers.

Consideration received for indemnification of risk under retroactive reinsurance contracts, including structured settlements, are accounted for as premiums earned at the inception of the contracts.

(k) 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 deferred 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 that arose subsequent to 1986 and at the rate of 28% relative to appreciation that arose in years prior to 1987.

In 1987, the Financial Accounting Standards Board ("FASB") issued Statement No. 96 "Accounting for Income Taxes," and implementation of the statement is now required in financial statements for years beginning after December 15, 1991. The statement requires the "liability method" of accounting for income taxes with a balance sheet focus superseding requirements for the "deferred method" with an earnings statement focus. The Company has not yet implemented the statement's provisions. The FASB has announced its intention to further defer the date required for implementation. If the current provisions of the Statement were to be given effect in Berkshire's consolidated balance sheet as of December 31, 1990, a reduction to shareholders' equity of no more than $70 million would result. The precise amount of the reduction is dependent upon Berkshire's selection between alternative means of implementation.

(m) Postretirement benefits other than pensions

In December, 1990, the FASB issued Statement No. 106 "Employers' Accounting for Postretirement Benefits Other Than Pensions." This statement alters generally accepted accounting principles with respect to employers' costs of providing retiree healthcare and other postretirement benefits other than pensions. The Company believes that the provisions of this statement will not have a measurable effect on Berkshire's financial position or results of operations.

(2) Business segment data

See page 39.

(3) Investments in obligations with fixed maturities

The amortized cost and estimated market value as of December 31, 1990 of investments in obligations with fixed maturities are as follows:

	Amortized Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Estimated Market Value*
Bonds:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 6,665,000	$ 84,000	$ —	$ 6,749,000
Obligations of states, municipalities and political subdivisions	576,588,000	87,622,000	(551,000)	663,659,000
Corporate bonds	514,547,000	13,787,000	(11,888,000)	516,446,000
Redeemable preferred stocks	1,963,275,000	120,141,000	(143,307,000)	1,940,109,000
	$3,061,075,000	$221,634,000	$(155,746,000)	$3,126,963,000

Shown below are the amortized cost and estimated market values of the above obligations at December 31, 1990, by contractual maturity dates. Expected maturities will differ from contractual maturities because issuers of certain of the obligations retain early call or prepayment rights.

	Amortized Cost	*Estimated Market Value*
Due in one year or less	$ 46,573,000	$ 56,922,000
Due after one year through five years	421,598,000	455,559,000
Due after five years through ten years *	2,091,645,000	2,097,990,000
Due after ten years	501,259,000	516,492,000
	$3,061,075,000	$3,126,963,000

* *Includes redeemable cumulative convertible preferred stock of The Gillette Company with an amortized cost of $600,000,000 and an estimated market value of $720,000,000 (see the following Note 4).*

During 1990, gross gains of $3,098,000 and gross losses of $1,468,000 were realized on sales and redemptions of obligations with fixed maturities.

(4) Investment in cumulative convertible preferred stock of The Gillette Company - subsequent event

On July 20, 1989, insurance subsidiaries of Berkshire purchased an Issue of 600,000 shares of redeemable Cumulative Convertible Preferred Stock of The Gillette Company ("Gillette"), each preferred share convertible under the terms of the Issue into 20 shares of Gillette common stock. The cash purchase price and par was $1,000 per share - $600,000,000 in the aggregate. Dividends with respect to the issue were at the annual rate of $87.50 per share. Under the terms of the Issue, Gillette possessed under certain circumstances the right, exercisable within a two-year period after issuance, to redeem the shares for cash at par if not converted by a date fixed by notice. Gillette gave notice of its exercise of that right on February 28, 1991, and the date of April 1, 1991 was fixed as the date for conversion of the shares into 12 million shares of Gillette common stock. The shares possess 11% of the voting rights of all Gillette voting shares.

Notes to Consolidated Financial Statements *(Continued)*

(5) Investments in redeemable cumulative convertible preferred stocks other than Gillette

Subsidiaries of Berkshire own issues of redeemable voting cumulative convertible preferred shares of companies other than Gillette as indicated in the following table:

Date of Issue	Issuer	Issue Price per share	Aggregate Cost	Dividend Accrual Rate	Required redemption Dates
10/1/87	Salomon Inc	$1,000	$700,000,000	9.00%	*
8/7/89	USAir Group Inc.	1,000	358,000,000	9.25%	8/7/99
12/6/89	Champion International Corp.	1,000	300,000,000	9.25%	12/6/99

**Salomon is required to redeem, at their issue price, 140,000 shares annually on October 31 commencing in 1995.*

Salomon Inc: The issue possessed 14% of Issuer's total outstanding voting rights at December 31, 1990, and each share of the issue is convertible, at Berkshire's option, at any time into 26.31579 common shares of the Issuer.

USAir Group Inc.: The issue possessed 12% of Issuer's total outstanding voting rights at December 31, 1990. After August 7, 1991, each share of the issue may be converted, at Berkshire's option, into 16 2/3 common shares of the Issuer, and, subject to prior conversion, each share may be redeemed, at Issuer's option, at $1,100 per share.

Champion International Corporation: The issue possessed 8% of Issuer's total outstanding voting rights at December 31, 1990. At any time each share of the issue is convertible at Berkshire's option into 26.31579 common shares of the Issuer, and, subject to prior conversion, each share may be redeemed, at Issuer's option, at $1,150 per share.

(6) 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(c) as to methods applied to determine carrying value of these securities.

	December 31, 1990			
	Cost	Unrealized Gain (Loss)	Market	Carrying Value
Common stock of:				
Capital Cities/ABC, Inc.	$ 517,500,000	$ 859,875,000	$1,377,375,000	$1,363,044,000
The Coca-Cola Company	1,023,919,000	1,147,631,000	2,171,550,000	2,168,812,000
GEICO Corporation	45,713,000	1,064,843,000	1,110,556,000	1,110,556,000
The Washington Post Company	9,731,000	332,366,000	342,097,000	342,097,000
Wells Fargo Company	289,431,000	(56,000)	289,375,000	287,341,000
All other marketable equity securities	398,386,000	69,882,000	468,268,000	414,133,000
	$2,284,680,000	$3,474,541,000	$5,759,221,000	$5,685,983,000

	December 31, 1989			
	Cost	Unrealized Gain	Market	Carrying Value
Common stock of:				
Capital Cities/ABC, Inc.	$ 517,500,000	$1,174,875,000	$1,692,375,000	$1,672,794,000
The Coca-Cola Company	1,023,919,000	779,868,000	1,803,787,000	1,801,995,000
GEICO Corporation	45,713,000	998,912,000	1,044,625,000	1,044,625,000
The Washington Post Company	9,731,000	476,635,000	486,366,000	486,366,000
Wells Fargo Company	55,124,000	5,436,000	60,560,000	60,560,000
All other marketable equity securities	162,673,000	130,572,000	293,245,000	195,258,000
	$1,814,660,000	$3,566,298,000	$5,380,958,000	$5,261,598,000

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

The 3,000,000 common shares of Capital Cities/ABC, Inc. ("Capital Cities") owned by Berkshire subsidiaries possessed approximately 18% of the voting rights of all Capital Cities shares outstanding at December 31, 1990. The shares are held subject to an Agreement, the terms of which grant to Capital Cities a right of first refusal to purchase the shares and otherwise govern until January 3, 1997 the manner by which the shares may be sold or transferred. Also, Berkshire and its subsidiaries have delivered to Capital Cities irrevocable proxies with respect to these shares in favor of Thomas S. Murphy or Daniel B. Burke, so long as either 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.

(8) Investment in GEICO Corporation

Subsidiaries of Berkshire, at both December 31, 1990 and at December 31, 1989, owned 6,850,000 shares of common stock of GEICO Corporation. The shares possessed approximately 48% of the voting rights of all GEICO shares outstanding at December 31, 1990, 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.

(9) Income taxes

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

	Dec. 31, 1990	*Dec. 31, 1989*
Payable currently	$ 49,672,000	$ 36,906,000
Deferred, relating to unrealized appreciation of marketable equity securities	1,085,342,000	1,100,784,000
Net prepaid arising from timing differences	(23,231,000)	(8,652,000)
	$1,111,783,000	$1,129,038,000

The Consolidated Statements of Earnings reflect charges for income taxes as shown below:

	1990	*1989*	*1988*
Federal	$ 94,713,000	$142,996,000	$122,492,000
State	16,779,000	15,514,000	15,871,000
Foreign	555,000	777,000	2,428,000
	$112,047,000	$159,287,000	$140,791,000
Current provision	$126,626,000	$171,616,000	$149,835,000
Increase in prepaid taxes	(14,579,000)	(12,329,000)	(9,044,000)
	$112,047,000	$159,287,000	$140,791,000

The increase in net prepaid taxes represent the tax effects of timing differences as follows:

Applicable to:	*1990*	*1989*	*1988*
Deferred insurance premium acquisition costs	$ (549,000)	$ (10,363,000)	$ (7,377,000)
Structured settlement liabilities	2,796,000	5,607,000	6,902,000
Discounting of losses and loss adjustment expense reserves	(8,515,000)	(3,588,000)	(10,988,000)
Deferred gross profit on installment receivables	(9,598,000)	(7,752,000)	(4,610,000)
Other, net	1,287,000	3,767,000	7,029,000
	$ (14,579,000)	$ (12,329,000)	$ (9,044,000)

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

	1990	*1989*	*1988*
Net earnings before income taxes	$516,466,000	$617,224,000	$550,121,000
Hypothetical amounts applicable to above computed at the Federal statutory rate	$175,598,000	$209,856,000	$187,041,000
Decreases, resulting from:			
Tax-exempt interest income	(19,744,000)	(26,735,000)	(33,477,000)
Dividends received deduction	(53,901,000)	(36,065,000)	(21,461,000)
State income taxes, less Federal income tax benefit	11,073,000	10,240,000	10,597,000
Net other differences	(979,000)	1,991,000	(1,909,000)
Total income taxes	$112,047,000	$159,287,000	$140,791,000

Notes to Consolidated Financial Statements *(Continued)*

(10) 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, 1990 and 1989.

Company	*1990*	*1989*
Zero Coupon Convertible Subordinated Notes Due 2004	$ 428,301,000	$ 405,683,000
10% Debentures due January 1, 2018, redeemable through operation of a sinking fund which calls for annual repayments of $7,500,000 beginning in 1999	150,000,000	150,000,000
9 3/4% Debentures due January 15, 2018, redeemable through operation of a sinking fund which calls for annual repayments of $5,000,000 beginning in 1999	100,000,000	100,000,000
Borrowings under obligations of investment agreements	324,801,000	109,120,000
Other notes, payable through 1993	7,475,000	9,396,000
	1,010,577,000	774,199,000
Subsidiaries		
8.125% Notes, payable in 1996	120,000,000	120,000,000
10% Notes, payable in annual installments of $2,625,000 through 1997 with a final payment of $2,750,000 on August 31, 1998	21,125,000	23,750,000
9 1/2% Notes, payable in annual installments of $2,500,000 through 1998	20,000,000	22,500,000
8 7/8% Notes, payable in 1999	30,000,000	30,000,000
Federal Home Loan Bank advance, due August 1994, bearing interest at 8.73%	16,900,000	16,900,000
Other notes maturing through 2014	20,756,000	20,167,000
	$1,239,358,000	$1,007,516,000

The Zero Coupon Convertible Subordinated Notes Due 2004 were issued on September 28, 1989 at 44.314% of their face value which totaled $902,640,000. The issue price reflected an original issue discount rate and yield to maturity of 5.5% per annum; there are no periodic payments of interest. Each $10,000 face amount note may be converted at any time prior to redemption into 0.4515 shares of common stock. A holder otherwise entitled upon conversion to a fractional share of common stock shall receive in lieu thereof cash equal to the then current market value of such fractional share. The conversion rate will be adjusted only upon occurrence of certain dilutive events affecting the common stock. The Company may redeem the notes for cash at any time after September 28, 1992. A holder may require the Company to purchase any of its holdings on September 28, 1994 and again on September 28, 1999. The price at which notes will be purchased or redeemed will be issue price plus accrued original discount to the date of purchase or redemption.

Borrowings under obligations of investment agreements are recorded at proceeds received. Obligations may be called at various times prior to maturity at the option of the counterparty. Interest rates on such borrowings range from 5.2% to 9.0%.

No materially restrictive covenants are included in any of the various borrowing agreements.

Principal payments on borrowings outstanding at December 31, 1990 are required during the succeeding five years as shown in the table immediately below. Amounts have been determined without regard to optional repayment provisions of the governing instruments.

1991	$ 30,852,000
1992	108,437,000
1993	99,520,000
1994	52,725,000
1995	5,612,000

(11) 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 31, 1987	$1,104,123,000	$1,614,221,000	$ 40,938,000
Increase during 1988 in unrealized appreciation included in carrying value of marketable equity securities	259,486,000		
Change during 1988 in deemed applicable income taxes	(88,763,000)		
Increase in minority shareholders' interest in unrealized appreciation	(189,000)		
Net earnings 1988		399,270,000	
Value of Berkshire stock received in connection with termination of pension plans			1,355,000
Balance at December 31, 1988	1,274,657,000	2,013,491,000	42,293,000
Increase during 1989 in unrealized appreciation included in carrying value of marketable equity securities	1,623,462,000		
Change during 1989 in deemed applicable income taxes	(552,314,000)		
Increase in minority shareholders' interest in unrealized appreciation	(3,607,000)		
Net earnings 1989		447,477,000	
Balance December 31, 1989	2,342,198,000	2,460,968,000	42,293,000
Decrease during 1990 in unrealized appreciation included in carrying value of marketable equity securities	(45,636,000)		
Change during 1990 in deemed applicable income taxes	15,441,000		
Increase in minority shareholders' interest in unrealized appreciation	(1,570,000)		
Net earnings 1990		394,093,000	
Balance December 31, 1990	$2,310,433,000	$2,855,061,000	$ 42,293,000

(12) Interest and dividend income

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

	1990	*1989*	*1988*
Interest earned with respect to:			
Investment securities	$132,694,000	$114,928,000	$164,499,000
Loans and financed receivables	53,985,000	50,904,000	51,135,000
Dividends with respect to:			
Fixed maturity preferred stocks	176,742,000	102,181,000	63,652,000
Marketable equity securities	86,874,000	63,439,000	34,965,000
	$450,295,000	$331,452,000	$314,251,000

(13) Interest expense

Interest expense is comprised of interest on savings accounts of Mutual Savings and Loan Association ("Mutual") plus interest on debt as follows:

	1990	*1989*	*1988*
Savings accounts of Mutual	$ 21,975,000	$ 21,261,000	$ 20,579,000
Debt of Mutual	1,475,000	599,000	—
Debt of Scott Fetzer Financial Group	12,868,000	13,325,000	14,088,000
Other debt	76,374,000	42,389,000	35,613,000
	$112,692,000	$ 77,574,000	$ 70,280,000

Notes to Consolidated Financial Statements *(Continued)*

(14) Dividend Restrictions - Insurance Subsidiaries

Payments of dividends by Insurance Group members are restricted by insurance statutes and regulations. Without prior regulatory approval in 1991, Berkshire can receive up to approximately $607,800,000 as dividends from insurance subsidiaries.

Combined shareholders' equity of insurance subsidiaries determined pursuant to statutory accounting rules (Statutory Surplus as Regards Policyholders) was approximately $6,300,000,000 at December 31, 1990. This amount exceeded by approximately $900,000,000 the corresponding amounts determined on the basis of generally accepted accounting principles; the difference is principally represented by deferred income tax liabilities recognized for financial reporting purposes but not for statutory reporting purposes.

(15) Quarterly data

A summary of revenues and earnings by quarter for each of the last two years is presented in the following table. This information is unaudited. Dollars are in thousands, except per share amounts.

	1ST QUARTER		2ND QUARTER		3RD QUARTER		4TH QUARTER	
	1990	1989	1990	1989	1990	1989	1990	1989
Revenues	$590,776	$701,707	$545,310	$564,214	$525,965	$597,143	$997,421	$620,828
Earnings excluding								
realized investment gain	$ 84,151	$ 72,241	$ 82,917	$ 62,424	$ 81,712	$ 70,932	$121,965	$ 94,305
- per share	73.40	63.01	72.32	54.45	71.27	61.87	106.39	82.49
Realized investment gain	$ 325	$ 54,813	$ 11,041	$ 25,011	$ 8,502	$ 50,723	$ 3,480	$ 17,028
- per share	0.29	47.81	9.63	21.82	7.42	44.25	3.03	14.34
Net earnings	$ 84,476	$127,054	$ 93,958	$ 87,435	$ 90,214	$121,655	$125,445	$111,333
- per share	73.69	110.82	81.95	76.27	78.69	106.12	109.42	96.83

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. 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 AUDITORS' 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, 1990 and 1989, and the related consolidated statements of earnings and cash flows for each of the three years in the period ended December 31, 1990. 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, 1990 and 1989, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1990, in conformity with generally accepted accounting principles.

DELOITTE & TOUCHE

March 8, 1991
Omaha, Nebraska

BERKSHIRE HATHAWAY INC.
Business Segment Data
(dollars in thousands)

Berkshire had seven reportable business segments as defined in Financial Accounting Standards Board Statement No. 14. 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 confectionery 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 of uniforms, trousers, jackets, shirts, and caps.

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

	Revenues			Operating profit before taxes		
	1990	1989	1988	1990	1989	1988
Insurance	$ 943,277	$ 865,026	$ 943,873	$316,207	$439,223	$347,900
Candy	196,119	186,053	168,166	38,605	33,260	31,498
Newspaper	135,211	135,647	131,664	43,382	45,448	41,830
Retailing of home furnishings	163,709	156,762	152,541	16,802	16,624	17,994
Encyclopedias, other reference materials	342,870	338,397	337,990	31,645	25,332	27,639
Home cleaning systems	188,292	158,959	144,145	28,479	26,188	27,210
Uniform manufacturing and distribution	94,554	93,930	92,514	11,727	11,899	13,425
Other	595,440	549,118	494,000	29,619	19,250	42,625
	$2,659,472	$2,483,892	$2,464,893	$516,466	$617,224	$550,121

Insurance Segment	Revenues			Operating profit before taxes		
	1990	1989	1988	1990	1989	1988
Premiums earned:						
Primary or direct	$154,015	$188,920	$292,309			
Reinsurance assumed	437,525	205,359	291,926			
Underwriting (loss)				$ (26,647)	$ (24,400)	$ (11,081)
Investment income	335,930	250,723	231,907	327,047	243,599	231,250
Realized investment gain	15,807	220,024	127,731	15,807	220,024	127,731
	$943,277	$865,026	$943,873	$316,207	$439,223	$347,900

	Capital expenditures			Deprec. & amort. of tangible assets			Identifiable assets at year-end		
	1990	1989	1988	1990	1989	1988	1990	1989	1988
Insurance	$ 601	$ 525	$ 838	$ 708	$ 918	$ 722	$ 8,884,393	$7,871,097	$5,421,195
Candy	6,970	3,882	3,509	3,752	3,574	3,392	69,833	66,278	64,304
Newspaper	2,229	971	988	2,909	2,757	2,836	48,286	48,917	50,755
Retailing of home furnishings	1,397	2,247	2,037	1,792	1,745	1,612	75,714	71,107	70,660
Encyclopedias, other ref. mat.	7,705	3,552	329	1,124	749	746	107,913	103,159	85,675
Home cleaning systems	3,859	11,191	2,370	5,285	3,274	2,575	66,388	60,147	45,675
Uniform manuf. and distr.	1,330	2,272	2,203	1,736	2,115	1,698	71,572	70,597	73,009
Other	9,832	17,897	5,418	13,236	13,589	13,421	1,346,324	1,168,292	1,005,575
	$33,923	$42,537	$17,692	$30,542	$28,721	$27,002	$10,670,423	$9,459,594	$6,816,848

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

Results of Operations

Net earnings for each of the past three years are disaggregated in the table that follows. Amounts are in thousands, and each figure is income tax-effected.

Activity or Item	Contribution to Net Earnings		
	1990	1989**	1988**
Insurance underwriting	$ (14,936)	$ (12,259)	$ (1,045)
Insurance segment investment income	282,613	213,642	197,779
	267,677	201,383	196,734
Manufacturing, merchandising, and services	132,209	124,129	126,260
Interest on debt*	(49,726)	(27,098)	(23,212)
Unallocated income/expense, net	20,585	1,488	13,659
Earnings before realized investment gain	370,745	299,902	313,441
Realized investment gain	23,348	147,575	85,829
Net earnings	$ 394,093	$ 447,477	$ 399,270

**Interest expense with respect to debt of consumer finance subsidiaries as well as interest expense of Mutual Savings & Loan Association is not reflected in "Interest on debt" but, instead, has been netted against the directly related service activity revenues.*

***Restated as required for comparability to 1990.*

The Business Segment data on the preceding page of this report should be read in conjunction with this discussion.

Insurance Underwriting

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

	000s Omitted		
	1990	1989	1988
Underwriting gain (loss):			
Primary or Direct Insurance Operations	$ 546	$ 4,243	$ 17,466
Reinsurance Assumed	(27,193)	(28,643)	(28,547)
Underwriting loss — pre-tax	(26,647)	(24,400)	(11,081)
Applicable income tax credit*	11,511	11,781	9,670
Applicable minority interest	200	360	366
After-tax underwriting loss	$(14,936)	$(12,259)	$ (1,045)

**Income tax credits applicable to underwriting losses include a "fresh start" tax benefit of approximately $2.3 million for 1990, $3 million for 1989, and $5 million for 1988.*

The Berkshire Hathaway Insurance Group engages in both insurance and reinsurance of property/casualty risks. In its "insurance" activities, as distinguished from its "reinsurance" activities, its members assume risks of loss from persons primarily and directly subject to the risks. In its reinsurance activities, the members assume defined portions of similar or dissimilar risks to which other insurers and reinsurers have subjected themselves in their own insuring activities.

Insurance Underwriting (continued)

Berkshire Hathaway Insurance Group members employ disciplined underwriting practices with the objective of rejecting underpriced risks. In each of the past four years, market prices (premium rates) have eroded as industry capital has increased in relation to industry premium volume. As a result the Insurance Group has successively underwritten fewer risks each year. Meanwhile, the amount of Berkshire capital devoted to the insurance industry increased each year. Statutory surplus as regards policyholders of the Berkshire Hathaway Insurance Group increased to approximately $6.3 billion at year-end 1990. This unique capital strength creates opportunities for Berkshire Group members to negotiate and enter into contracts of insurance specially designed to meet unique needs of sophisticated insurance and reinsurance buyers having forward looking concerns about capital adequacy and solvency of their insurers.

Primary or Direct Insurance Underwriting

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)

	1990		1989		1988	
	Amount	%	Amount	%	Amount	%
Premiums written	$139,085		$169,661		$218,838	
Premiums earned	$154,015	100.0	$188,920	100.0	$292,309	100.0
Losses and loss expenses	102,033	66.2	125,873	66.6	196,165	67.1
Underwriting expenses	51,436	33.4	58,804	31.1	78,678	26.9
Total losses and expenses	153,469	99.6	184,677	97.7	274,843	94.0
Underwriting gain — pre-tax	$ 546		$ 4,243		$ 17,466	

Favorable development, discussed on the following page, of beginning-of-the-year loss reserves representing respectively, 11.9%, 10.6% and 10.0% of premiums earned in 1990, 1989 and 1988, were credited to losses and expenses of those years. Without those credits (or, stated differently, if only estimated losses and expenses from occurrences of the current year were related to amounts shown in the table for premiums earned for the current year), total losses and expenses as a percentage of premiums earned would equal: 1990 — 111.5%, 1989 — 108.3%, and 1988 — 104.0%.

The number of risks accepted in Berkshire's primary or direct insurance operations peaked in 1986 and has declined significantly each succeeding year. The declines have been shared by each of the underwriting units that produce the Group's direct business, as reflected in the following table of premiums earned for the past four years:

(Dollars in millions)

Underwriting Unit	1990	1989	1988	1987
Traditional motor vehicle/general liability operations	$ 94	$113	$168	$268
N.Y. commercial casualty/professional liability/specialty risk operations	18	20	54	93
Homestate companies/Cypress Insurance Co.	42	56	70	80
Total premiums earned	$154	$189	$292	$441

The "traditional" business is written through general agents located nationwide directed from National Indemnity's Omaha offices. The operations are termed internally as those of the "National Indemnity primary group." Historically from the founding of National Indemnity Company fifty years ago, the volume of business written by this group varied significantly from year to year, increasing during periods of limited industry insuring capacity and decreasing when that capacity expanded. When capacity was adequate, much of the business was written by competing insurers (i) charging prices lower than those acceptable to National Indemnity, and (ii) applying less stringent underwriting guidelines than those applied by National Indemnity. Those lower prices continued until the resulting unacceptable losses caused a voluntary or involuntary exit from the market by some of those other insurers. At such point in the cycle, National Indemnity Company

Management's Discussion *(continued)*

Insurance Underwriting (continued)

and its affiliated Insurance Group members were offered increased opportunities to underwrite the risks at prices they believed to be adequate. In recent years, the group has experienced the down-side of this cycle. The upside, evidenced by increased offerings meeting the Group's acceptance standards, has not yet been observed.

Disciplined underwriting is also practiced by the Group's New York City underwriting units that commenced operations in 1985. Earned premiums from policies underwritten from these offices peaked at $93 million in 1987 and then declined each year since, totalling $18 million in 1990. These commercial casualty/professional liability and special risks underwriting units generate "tailored" insurance contracts for insureds presenting unusual and/or unusually large risks. Many standard carriers decline to provide such coverages when their capacity can be fully employed in providing standard coverages for standard risks, i.e., in tight markets such as those of 1985 and 1986, but those carriers have increasingly competed for, and written much of the business in the 1987-1990 period.

The Homestate companies of the Berkshire Hathaway Insurance Group — in Colorado, Kansas and Nebraska — reduced their premium writings in each of the past two years. Their disciplined underwriting approach in a soft market environment resulted in loss of market share. In California, Cypress Insurance Company significantly reduced its in-force workers' compensation business as a result of a highly competitive market as well as management turnover at the unit.

The preceding discussion is given to explain the downward trend in dollar amount of premiums. It should be understood that no management judgments with respect to the Insurance Group's operations are based on volume of business done. Instead, members are encouraged to reject underpriced risks without regard to volume.

Summarized below is loss and loss expense data from primary or direct insurance underwriting:

	000s Omitted		
	1990	1989	1988
Unpaid losses and loss expenses at beginning of year	$639,146	$667,592	$628,077
Incurred losses recorded:			
Current year occurrences	120,376	145,907	225,309
All prior years' occurrences	(18,343)	(20,034)	(29,144)
	102,033	125,873	196,165
Payments with respect to:			
Current year occurrences	21,742	27,645	39,263
All prior years' occurrences	132,851	126,674	117,387
	154,593	154,319	156,650
Unpaid losses and loss expenses at end of year	$586,586	$639,146	$667,592

Credits against incurred losses were recorded in each of the last three years for "all prior year occurrences." They are corrections of estimation error that are credited or charged to earnings in the year made. Relating these credits for each year to the related estimated unpaid amounts at the beginning of the respective year, the "savings" were: 1990 — 2.9%, 1989 — 3.0% and 1988 — 4.6%. It would be comforting to Berkshire's management and shareholders to infer that the "savings" reveal that the estimated beginning-of-the-year unpaid amounts were too high and by a measurable amount that fell between 2.9% and 4.6%. But that would be wrong because, obviously, all of the cases have not been settled. However, several years of favorable loss development is more comforting than several years of unfavorable development, and 1990 was the Insurance Group's fourth successive year of favorable development for the primary or direct operations. For 1987, the first of the four, favorable development amounted to 2.2% of beginning-of-the-year estimated unpaid amounts. In contrast, however, for 1986, unfavorable development was recorded, amounting to 7.6% of the beginning liability.

Insurance Underwriting (continued)

The favorable development recorded in 1989 and 1990 related principally to the traditional commercial automobile business of the "primary group" defined above. That was true of $14 million of 1988 savings, while an additional $8.5 million of that year's savings derived from excess-of-loss claims-made type liability coverages.

Reinsurance Assumed

In past years, in this section, we set apart the structured settlement activity from the "conventional" reinsurance activity. However, all of the reinsuring activities of the Berkshire Hathaway Insurance Group are combined for purposes of this 1990 discussion and, accordingly, prior year data shown in the following three tables are restated from prior years' presentations.

In 1990, the Insurance Group derived the majority of their insurance premium volume from reinsurance contracts that insured other insurers and reinsurers against sustaining adverse loss development with respect to their own loss reserves. These were sizeable contracts that generated 1990 premium income of $378 million.

Underwriting results, determined on a GAAP basis, with respect to the reinsurance assumed business for the past three years are summarized in the following table.

	Dollars in Thousands					
	1990		1989		1988	
	Amount	%	Amount	%	Amount	%
Premiums written	$435,205		$126,430		$265,871	
Premiums earned	$437,525	100.0	$205,358	100.0	$291,926	100.0
Losses and loss expenses	432,228	98.8	183,518	89.4	241,530	82.7
Underwriting expenses	32,490	7.4	50,484	24.5	78,943	27.1
Total losses and expenses	464,718	106.2	234,002	113.9	320,473	109.8
Underwriting (Loss) — pre-tax	$(27,193)		$(28,644)		$(28,547)	

Disaggregated data relating to reinsuring activities of the Insurance Group are presented below.

	Dollars in Millions								
	Premiums Earned			Underwriting Loss			Year-End Reserves*		
	1990	1989	1988	1990	1989	1988	1990	1989	1988
Major quota share reinsurance	$ —	$130.6	$215.5	$ —	$ 9.0	$ 12.3	$ 332.6	$411.9	$434.8
Other reinsurance except structured settlements	383.7	17.4	16.8	5.5	3.5	7.3	866.4	188.2	175.9
Structured settlements	53.8	57.4	59.6	21.7	16.1	8.9	264.7	197.1	128.9
	$437.5	$205.4	$291.9	$27.2	$ 28.6	$ 28.5	$1,463.7	$797.2	$739.6

**Unpaid losses and loss adjustment expenses*

Premiums earned from major quota share reinsurance shown above for 1989 and 1988 reflect those from the arrangement under which, for a four year term from September 1, 1985 through August 31, 1989, National Indemnity assumed 7% of the business written by the Fireman's Fund Insurance Companies.

For the category in the above table captioned "other reinsurance excluding structured settlements," the premiums earned in 1990 preponderantly represent the consideration received for the adverse loss development contracts referred to in the second paragraph of this discussion of reinsurance assumed. No underwriting gain or loss was recorded for 1990 with respect to those contracts entered into in the fourth quarter of 1990. Amortization of the $350,787,000 deferred charges established in 1990 with respect thereto will commence in 1991.

The underwriting loss from structured settlements in each of the past three years reflect principally accretion of the liabilities therefor, except that a modest amount of actuarial gain was credited in 1989.

Management's Discussion *(continued)*

Insurance Segment Investment Income

Following is a summary of Insurance Group net investment income for the past three years.

	000s Omitted			
	Investment Income Before Taxes	Applicable Income Taxes	Applicable Minority Interest	Investment Income After Taxes and Minority Int.
1990	$327,047	$ 41,264	$ 3,170	$282,613
1989	243,599	26,756	3,201	213,642
1988	231,250	30,698	2,773	197,779

Invested assets increased in each of the past three years. During that period, Berkshire contributed approximately $900 million additional capital to the Group, and reinvested earnings of the Group for that period amounted to approximately $850 million. Additionally contributing to the increase in invested assets during the three-year period was about $175,000,000 increased "float" from policyholder funds. (That term denotes the sum of unpaid losses, unpaid loss adjustment expenses and unearned premiums, less the aggregate of agents' balances receivable, amounts recoverable as reinsurance on paid losses, deferred policy acquisition costs and deferred charges re reinsurance, the net amount of which totalled approximately $1,632,000,000 at the end of 1990.)

The Insurance Group received 1990 dividend income of $52,500,000 with respect to its $600,000,000 investment in the Gillette convertible preferred stock that will be converted on April 1, 1991 into Gillette common stock. Annual dividends from such common stock, at Gillette's current common dividend payment rate, would amount to approximately $13,000,000. Thus, some decrease from the 1990 level of Insurance Group investment income may occur in 1991.

Manufacturing, Merchandising and Services

Results of operations for the past three years of Berkshire's diverse non-insurance businesses are aggregated in the following table. Dollar amounts are in thousands.

	1990		1989		1988	
	Amount	%	Amount	%	Amount	%
Revenues	$1,657,025	100.0	$1,601,858	100.0	$1,486,194	100.0
Costs and expenses	1,429,652	86.3	1,389,317	86.7	1,274,466	85.8
Earnings before income taxes	227,373	13.7	212,541	13.3	211,728	14.2
Applicable income taxes	88,952	5.4	82,644	5.2	80,154	5.4
Applicable minority interest	6,212	0.3	5,768	0.4	5,314	0.4
Net earnings	$ 132,209	8.0	$ 124,129	7.7	$ 126,260	8.4

Amounts reflected above for "Revenues" exclude certain items of investment income earned by the corporate entities conducting these businesses where that income is not clearly attributable to the capital allocated to the businesses. Such items aggregated $40.9 million for 1990. Lesser amounts of such items were earned in prior years — $11.6 million in 1989 and $14.5 million in 1988, but for purposes of comparability to 1990 data, data for the prior years are restated to remove the items and their effects on taxes, minority interest and earnings.

The above data for 1990 and 1989 represents the combined results from operations of the non-insurance businesses — including the six non-insurance "reportable business segments" — identified on page 50 plus financing operations of the Scott Fetzer Financial Group, plus operations of Mutual Savings and Loan Association and moderate scale real estate management activities of Berkshire and Wesco.

Manufacturing, Merchandising and Services (continued)

Revenues of the six non-insurance reportable business segments were greater in 1990 than in 1989 by approximately $51 million or about 5%, and their operating profits before taxes were greater in 1990 than in 1989 by approximately $12 million or about 7% Thus, virtually all of the increased 1990 revenues and pre-tax profits from the twenty five-plus operations were generated by those six business segments. Further information about each of the six follows.

See's Candy Business

See's candy business recorded its highest-ever annual sales volume in 1990. However, the physical volume was up over 1989 by less than 1%. An increase of approximately 4.5% in pounds sold in response to quantity orders was reduced by a decrease of about 2% in pounds sold from the retail stores. A selling price increase of about 5%, initiated at the beginning of the year, together with the slight increase in physical volume of sales, resulted in a $10.1 million, 5.4% increase in 1990 candy sales revenue over 1989.

The slowing in 1990 retail store volume was more notable in the last quarter of the year. Reduced traffic at West Coast mall stores has continued into 1991. Unless this pressure abates on retail sales, it is unlikely that increases in revenue or operating profit can be achieved at See's in the current year, notwithstanding some increase in 1991 selling prices.

Newspaper Business

The total newspaper revenues for the first nine months of 1990 were about 1% ahead of, and pre-tax profits were virtually unchanged from, those for the prior year's first nine months. However, in 1990's fourth quarter, a marked decline occurred in virtually every category of advertising lineage and revenue, with the result that revenues at the Buffalo News were down from 1989's fourth quarter periods by approximately $1.3 million, or 3%.

As a result of the fourth quarter recessionary pressures, newspaper operating profits before taxes declined 5% in 1990 to $43.4 million, from $45.4 million in 1989. The decrease in annual profits is the first experienced for the Buffalo News since Berkshire succeeded to 100% from its earlier 60% ownership of the paper in 1983 (when the paper's annual operating profits were $19 million). But, the pressures on revenues and earnings are seen as continuing, so that another and somewhat greater decline is in prospect for the paper's 1991 earnings.

Retailing of Home Furnishings

The Nebraska Furniture Mart's revenues increased 4% in 1990 over 1989. However, 1990's fourth quarter sales increased by a lesser 1%. Higher 1990 sales came primarily from increased sales of electronics and appliances, as the Mart increased its share of the area market for those products.

Costs at the Mart in 1990 increased over 1989 at a greater rate than sales. In addition to inflationary pressures, 1990 added costs were incurred to achieve improved customer service, particularly payroll costs for added point-of-sale personnel.

Encyclopedias, Other Reference Materials

Revenues of this segment were about 1% higher for 1990 than for 1989. International sales increased as did domestic sales of publications other than encyclopedias. Domestic unit sales of and dollar revenue from the latter declined in each of the past two years. Response to domestic special promotions of the encyclopedias was disappointing in 1990, possibly because of inadequate recruitment of sales representatives.

Pre-tax profit of this segment in 1990 increased over 1989 by approximately $6.3 million, or 25%, to $31.6 million. Among other factors contributing to this increase were lower 1990 costs relating to relocating and reorganizing the activities of the segment. Such costs incurred were $6.9 million in 1989 versus $1.5 million in 1990. Also foreign currency exchange gains of approximately $700,000 were recorded for the segment in 1990, contrasted to foreign exchange losses in 1989 that amounted to approximately $550,000.

Management's Discussion *(continued)*

Manufacturing, Merchandising and Services (continued)

Home Cleaning Systems

Introduction in 1990 of the Generation III model Kirby vacuum cleaner generated significant consumer response. Unit sales of Kirby cleaners in 1990 were up 8% domestically and 20% internationally over 1989. The unit price of the new model is higher than for the replaced Legend II model, so that dollar revenues of this segment increased 18% from 1989 to 1990. Success in marketing the new Kirby product masked a $2 million decline in 1990 from sales, principally to retailers, of specialty vacuum products.

Fechheimer Uniforms

Revenues from this uniform manufacturing and marketing operation were up slightly — 1% — in 1990 over 1989. Operating profits of the operation would have been slightly higher in 1990 than for those of the prior year except for a $500,000 gain realized in the prior year's fourth quarter upon sale of a parcel of unused, appreciated real estate. Fourth quarter 1990 results also compared unfavorably with fourth quarter 1989 results because of a larger than anticipated year-end LIFO inventory adjustment. Except for the latter bookkeeping adjustment, levels of profitability of the segment gradually improved during 1990 as problems gradually decreased in integrating into the operations a manufacturing facility acquired in 1989. Further improved operating results from this segment are in prospect for 1991.

Interest Expense

Interest on debt increased in both 1990 and 1989, reflecting increased outstanding borrowings. Both the 1989 and 1990 increases reflect the expense recorded for accretion of the zero coupon convertible subordinated notes issued on September 28, 1989. The 1990 increase over 1989 additionally reflects the added borrowing costs with respect to the increase in the average outstanding obligations under investment contracts.

Realized Investment Gain

Realized investment gain has been a recurring element in Berkshire's net earnings for many years. The amount — recorded by Berkshire when appreciated securities are sold — tends to fluctuate significantly from period to period, with a meaningful effect upon Berkshire's consolidated net earnings. But, 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, 1990, reflects continuing capital strength. Berkshire shareholders' equity has increased from approximately $2.84 billion at December 31, 1987 to approximately $5.29 billion at December 31, 1990. In that three-year period, realized and unrealized securities gains increased equity capital by approximately $1.46 billion. Reinvested earnings, other than realized securities gains, were approximately $984 million for the three years.

In early 1991, Standard and Poor's Corporation reaffirmed its assignment of a AAA credit rating to Berkshire senior debt. Indebtedness of creditors that is subordinated to senior debt normally receives a rating one gradation lower than for the senior debt. Accordingly, Berkshire's issue of zero coupon subordinated notes retains an AA+ rating from that rating agency.

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. The Commercial Casualty/Professional Liability/Special Risks Division, with offices in New York City, solicit and underwrite the latter. 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 principally workers' compensation insurance to employers in that state.

A Reinsurance Division in New York City provides treaty reinsurance to other property/casualty insurers and reinsurers. This division is currently one of the leading providers in the world of financial type reinsurance and property/catastrophe retrocessional protection (i.e., reinsurance for reinsurers).

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 1990 were approximately 9% of the Group's year-end statutory surplus. That compares to an industry average premiums-to-surplus ratio of about 155% (for 1989). The obvious margins of safety thus provided to insureds of the Group are particularly persuasive in marketing of individually negotiated insurance and reinsurance contracts.

Combined financial statements of the Berkshire Hathaway Inc. Insurance Group - unaudited and not fully adjusted to conform to Generally Accepted Accounting Principles - are presented on the following two pages.

BERKSHIRE HATHAWAY INC.

INSURANCE GROUP

Balance Sheets
(dollars in millions)

	December 31, 1990	December 31, 1989
Assets		
Investments:		
Fixed maturities at amortized cost:		
Bonds:		
RJR Nabisco	$ 187.7	$ 136.5
Wash. Pub. Power Supply System	188.9	194.0
Other	377.4	409.4
Redeemable preferred stocks:		
Champion International	279.0	279.0
Gillette	600.0	600.0
Salomon Inc	637.0	624.0
USAir	348.0	348.0
Other	0.7	0.7
Equity securities at market:		
Common stocks:		
Capital Cities/ABC, Inc.	1,354.4	1,664.2
Coca-Cola Company	2,166.0	1,799.2
GEICO	1,110.6	1,044.6
Washington Post	342.1	486.4
Wells Fargo Company	278.7	60.6
Other	232.9	63.1
Nonredeemable preferred stocks	72.6	23.5
	8,176.0	7,733.2
Cash and cash equivalents	115.6	45.4
Receivables	222.2	71.0
Deferred costs	364.2	15.0
Other	2.3	2.3
	$8,880.3	$7,866.9
Liabilities		
Loss and loss adjustment expenses	$2,050.3	$1,436.3
Unearned premiums	126.4	143.6
Accounts payable, accruals and other	226.0	201.0
Income taxes (Deferred: $1,081.1, 1990; $1,095.3, 1989)	1,099.0	1,136.2
	3,501.7	2,917.1
Equity		
Minority shareholders'	39.8	35.2
Berkshire shareholders'	5,338.8	4,914.6
	5,378.6	4,949.8
	$8,880.3	$7,866.9

These statements do not conform to GAAP in all respects
These statements are unaudited

BERKSHIRE HATHAWAY INC.

INSURANCE GROUP

Statements of Earnings
(dollars in millions)

	1990	1989	1988
Premiums written	$ 574.3	$ 296.1	$ 484.7
Premiums earned	$ 591.5	$ 394.3	$ 584.2
Losses and loss expenses	534.2	309.4	437.7
Underwriting expenses	83.9	109.3	157.6
Total losses and expenses	618.1	418.7	595.3
Underwriting loss - pre-tax	(26.6)	(24.4)	(11.1)
Net investment income	327.0	243.9	231.2
Realized investment gain	15.8	220.6	127.9
Earnings from operations before income taxes	316.2	440.1	348.0
Income tax expense	(34.1)	(88.9)	(63.7)
	282.1	351.2	284.3
Minority interest	3.0	4.0	3.6
Net earnings	$ 279.1	$ 347.2	$ 280.7

Statements of Net Investment Income
(dollars in millions)

	1990	1989	1988
Interest:			
Substantially exempt from Federal income taxes:			
Wash. Pub. Power Supply System	$ 27.1	$ 27.3	$ 34.6
Other	30.5	51.6	64.6
Taxable:			
RJR Nabisco	27.0	3.4	—
Other	6.6	18.5	46.7
	91.2	100.8	145.9
Dividends:			
Capital Cities/ABC, Inc.	0.6	0.6	0.6
Champion International	25.8	1.9	—
Coca-Cola Company	37.3	31.3	4.4
GEICO	13.7	12.3	11.2
Gillette	52.5	23.5	—
Salomon Inc	56.1	56.1	56.1
USAir	32.2	12.9	—
Washington Post	6.9	3.2	2.7
Wells Fargo Company	10.8	2.0	—
Other	8.8	6.1	11.0
	335.9	250.7	231.9
Investment expenses	(8.9)	(6.8)	(0.7)
Net investment income	$ 327.0	$ 243.9	$ 231.2

These statements do not conform to GAAP in all respects
These statements are unaudited

BERKSHIRE HATHAWAY INC.

MANUFACTURING, PUBLISHING AND RETAILING BUSINESSES

Combined financial statements of Berkshire's Manufacturing, Publishing and Retailing businesses - unaudited and not fully adjusted to conform to Generally Accepted Accounting Principles - 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
Borsheim's	Retailing of fine jewelry
Campbell Hausfeld	Air compressors and accessories, painting systems
Carefree	Roll-up awnings, other RV accessories
France	Appliance controls, ignition and sign transformers
Halex	Zinc and aluminum die cast fittings
K&W Products	Automotive compounds
Meriam	Pressure and flow measurement devices
New America Electric	Manufacturer of electrical equipment
Northland	Fractional horsepower motors
Powerwinch	Boat winches, windlasses
Precision	Steel service center
Quikut	Varieties of cutlery
Scot Labs	Cleaning and maintenance chemicals
Stahl	Custom steel services bodies and tool boxes for trucks
Wayne Home Equipment	Furnace burners; sump, utility and sewage pumps
Western Enterprises	Compressed gas fittings and regulators
Western Plastics	Molded plastic components

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 forty-two 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 700 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* manufactures 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 confectionery 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 publishes educational products for homes, schools, and libraries. Its chief products include: *The World Book Encyclopedia*, the world's largest-selling encyclopedia; *Childcraft*, a resource library for young children; and *Early World of Learning*, a readiness program for preschoolers. These and other educational material are marketed in the United States and Canada by a large direct-selling force of some 35,000 members. A newly copyrighted edition of *World Book* is published each year. *The World Book Year Book*, an updating publication for owners of earlier editions, and other products are sold by direct mail and telemarketing. An international group distributes these and other specially created products in Australia, the British Isles, and other key markets around the world.

BERKSHIRE HATHAWAY INC.

MANUFACTURING, PUBLISHING and RETAILING BUSINESSES

Balance Sheets
(dollars in millions)

	December 31, 1990	December 31, 1989
Assets		
Cash and cash equivalents	$ 28.9	$ 25.2
Accounts receivable	184.0	175.6
Inventories	174.1	165.7
Properties and equipment	149.1	141.9
Other	19.7	18.4
	$ 555.8	$ 526.8
Liabilities		
Accounts payable, accruals and other	$ 198.0	$ 214.2
Income taxes	38.4	37.9
Term debt and other borrowings	36.1	38.0
	272.5	290.1
Equity		
Minority shareholders'	28.2	25.2
Berkshire shareholders'	255.1	211.5
	283.3	236.7
	$ 555.8	$ 526.8

Statements of Earnings
(dollars in millions)

	1990	1989	1988
Revenues:			
Sales and service revenues	$1,580.1	$1,526.4	$1,407.6
Interest income	6.7	8.4	6.7
Sundry income	1.4	2.6	2.5
	1,588.2	1,537.4	1,416.8
Costs and expenses:			
Costs of products and services sold	865.6	838.7	747.8
Selling, general and administrative	499.3	487.7	461.8
Interest on debt	6.5	6.2	4.9
	1,371.4	1,332.6	1,214.5
Earnings from operations before income taxes	216.8	204.8	202.3
Income tax expense	83.9	78.9	76.2
	132.9	125.9	126.1
Minority interest	5.4	5.0	4.4
Net earnings	$ 127.5	$ 120.9	$ 121.7

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 53.

These statements do not conform to GAAP in all respects
These statements are unaudited

BERKSHIRE HATHAWAY INC.

FINANCE-TYPE BUSINESSES

Mutual Savings and Loan Association and its subsidiary and *Scott Fetzer Financial Group, Inc.* and its subsidiaries make up Berkshire's finance-type operations.

Balance Sheets
(dollars in millions)

	December 31, 1990	December 31, 1989
Assets		
Cash and cash equivalents	$ 72.9	$ 40.0
Investments at cost:		
Fixed maturities:		
Bonds	17.0	17.5
Redeemable preferred stocks	17.5	30.5
Equity securities:		
FHLMC common stock	71.7	71.7
Nonredeemable preferred stocks	36.8	36.8
Collateralized loans receivable (1)	131.1	153.8
Installment and other receivables	169.7	173.2
Prepaid income taxes	11.1	12.9
Other	21.2	17.2
	$ 549.0	$ 553.6
Liabilities		
Savings accounts	$ 286.4	$ 293.1
Accounts payable, accruals and other	22.2	18.4
Income taxes	1.3	1.5
Term debt and other borrowings	157.1	159.6
	467.0	472.6
Equity		
Minority shareholders'	10.1	9.7
Berkshire shareholders'	71.9	71.3
	82.0	81.0
	$ 549.0	$ 553.6

Statements of Earnings
(dollars in millions)

	1990	1989	1988
Revenues:			
Interest and fees on loans and financed receivables	$ 51.9	$ 49.4	$ 50.2
Interest and dividends on investment securities	18.3	19.2	20.9
Sundry income	0.3	0.3	0.6
	70.5	68.9	71.7
Expenses:			
Interest on savings accounts	22.0	21.5	20.8
Interest on debt	14.3	13.9	14.1
General and administrative	20.7	20.8	23.3
	57.0	56.2	58.2
Earnings from operations before income taxes	13.5	12.7	13.5
Income tax expense	1.7	1.2	2.0
	11.8	11.5	11.5
Minority interest	0.8	0.8	1.0
Net earnings	$ 11.0	$ 10.7	$ 10.5

(1) Includes mortgage-backed securities of $23.7, 1990 and $34.3, 1989.

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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, and not fully GAAP - adjusted group financial statements heretofore presented (pages 47 to 52).

Statements of Net Assets
(dollars in millions)

	December 31	
	1990	1989
Assets		
Cash and cash equivalents	$ 29.9	$ 96.0
Investments:		
Fixed maturities		
Bonds:		
RJR Nabisco	252.6	74.8
Other	74.3	0.2
Redeemable preferred stocks	81.0	81.0
Common stocks	20.1	11.5
Property account adjustments (1)	73.6	79.5
Unamortized goodwill (1)	136.5	140.5
Prepaid income taxes	8.0	9.0
Other	32.8	64.7
	$ 708.8	$ 557.2
Liabilities		
Accounts payable, accruals and other	$ 33.8	$ 31.6
Income taxes	(7.8)	(24.7)
Term debt and other borrowings	1,046.2	809.9
	1,072.2	816.8
Equity		
Minority shareholders'	15.0	12.7
Berkshire shareholders'	(378.4)	(272.3)
	(363.4)	(259.6)
	$ 708.8	$ 557.2

Statements of Earnings
(dollars in millions)

	1990	1989	1988
Revenues:			
Interest and dividend income	$ 41.1	$ 7.2	$ 7.4
Sundry income	20.2	9.3	28.5
	61.3	16.5	35.9
Expenses:			
Corporate administration	4.1	3.4	3.8
Shareholder designated contributions	5.8	5.9	5.0
Amortization of goodwill (1)	3.5	3.4	2.7
Property account adjustments (1)	6.0	6.0	6.9
Interest on debt	71.3	37.3	30.7
Other costs and expenses	0.6	0.9	0.5
	91.3	56.9	49.6
Excess of expenses before income taxes	(30.0)	(40.4)	(13.7)
Income tax credit	7.6	9.8	1.2
	(22.4)	(30.6)	(12.5)
Minority interest	1.1	0.6	1.1
Net loss	$ (23.5)	$ (31.2)	$ (13.6)

(1) "Property account adjustments" and goodwill arose in accounting for business acquisitions.

These statements do not conform to GAAP in all respects
These statements are unaudited

BERKSHIRE HATHAWAY INC.

SHAREHOLDER-DESIGNATED CONTRIBUTIONS

The Company has conducted this program of corporate giving during each of the past ten years. On October 14, 1981, the Chairman sent to the shareholders a letter* explaining 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 own 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.

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"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
1989	$6	96.9%	$5,867,254	2,550
1990	$6	97.3%	$5,823,672	2,600

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

In addition to the shareholder-designated contributions summarized above, Berkshire and its subsidiaries have 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 the contributions would produce substandard or no tax deductions. In other years Berkshire expects to inform shareholders of the amount per share that may be designated, and a reply form will accompany the notice allowing shareholders to respond with their designations. If the program is conducted in 1991, the notice will be mailed on or about September 15 **to shareholders of record reflected in our Registrar's records as of the close of business August 31, 1991**, and shareholders will be given until **November 15** to respond.

Shareholders should note the fact that shares held in street name are not eligible to participate in the program. To qualify, shares must be registered on August 31 in the owner's individual name(s) or the name of an owning trust, corporation, partnership or estate, as applicable.

The 1990 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:

Wesco has three major subsidiaries, Mutual Savings, in Pasadena, Wesco-Financial Insurance Company, headquartered in Omaha and currently engaged principally in the reinsurance business, and Precision Steel, headquartered in Chicago and engaged in the steel warehousing and specialty metal products businesses. 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, 1990		December 31, 1989	
	Amount	Per Wesco Share	Amount	Per Wesco Share
"Normal" net operating income of:				
Mutual Savings	$ 4,099	$ .58	$ 4,191	$ .59
Wesco-Financial Insurance business	14,924	2.10	14,276	2.00
Precision Steel's businesses	1,985	.28	2,769	.39
All other "normal" net operating income[2]	4,030	.56	3,178	.45
	25,038	3.52	24,414	3.43
Net gains on sales of marketable securities	391	.05	5,920	.83
Wesco consolidated net income	$25,429	$3.57	$30,334	$4.26

(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, interest and dividend income from cash equivalents and marketable securities owned outside the savings and loan and insurance subsidiaries, and the electrical equipment manufacturing business, 80%-owned by Wesco since yearend 1988.

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 $4,099,000 in 1990 was almost equal to the $4,191,000 figure the previous year.

As usual, these "normal-income" figures come from an abnormal savings and loan association.

Separate balance sheets of Mutual Savings at yearend 1989 and 1990 are set forth at the end of this annual report. They show (1) total savings accounts declining to $286 million from $293 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 $131 million at the end of 1990, down moderately from $154 million at the end of 1989.

As pointed out in Note 9 to the accompanying financial statements, the book value of Wesco's equity in Mutual Savings overstates the amount realizable, after taxes, from sale or liquidation at book value. Wesco would get only about $30.8 million, after paying income taxes, from the liquidation at book value of the $47 million portion of Mutual Savings' shareholders' equity which is considered bad debt

* A few small sections of Mr. Munger's letter have been excluded: When Berkshire's report exceeds 72 pages, we have problems in binding it. Because of this limitation, either Charlie's letter or mine had to be cut and I decided a coin flip was appropriate. In fact - as things turned out - I finally decided nine flips were appropriate. — W. E. B.

reserves for income tax purposes. The $4.1 million Mutual Savings earned in 1990 is an inadequate return (8.7%) on the $47 million amount at which we try to maintain shareholders' equity, but this same $4.1 million is a respectable return (13.3%) on the $30.8 million which would be the after-tax proceeds of liquidation at book value.

The loan portfolio at the end of 1990, although containing almost no risk of loss from defaults, bore an average interest rate of only 9.20%, probably near the lowest among U.S. savings and loan associations and roughly the same as the 9.23% rate at the end of 1989. 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 much 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, 1990 was about $11 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 again last year. The "spread" improved because interest rates paid on savings declined. 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 and other costs, if the general level of interest rates should sharply rise. In view of this risk, Mutual Savings' total commitment has been kept conservative, relative to the amount of its net worth.

New federal legislation enacted in 1989, widely known under the acronym "FIRREA," is now causing Mutual Savings, step by step, to dispose of the preferred stock portion ($54.4 million, at cost, at December 31, 1990) of its tax-advantaged assets. Ownership of preferred stock has heretofore helped preserve earning power because tax-equivalent yield is so high (about 15% at December 31, 1990). Adding to our forced-disposition-of-desirable-assets problem, recent changes in income-tax law now make impracticable the replacement, as they mature, of Mutual Savings' direct holdings of municipal bonds ($16.9 million, at cost, at December 31, 1990). The municipal bonds also have a high tax-equivalent yield (about 17.5% at December 31, 1990). By mid-1994, and possibly much sooner, we expect virtually all benefit from tax-advantaged investment to vanish from Mutual Savings.

Mutual Savings remains a "qualified thrift lender" under the old federal regulatory standard (which ends June 30, 1991) requiring 60% of assets to be in various housing-related categories. It will shortly change its asset mix as necessary to comply with a new standard, imposed by FIRREA, which requires that 70% of assets be maintained in a more restricted list of housing-related assets.

Until U.S. laws governing financial institutions are further revised, Mutual Savings expects to keep its required 70% in housing-related assets within the following five categories:

(1) mortgages issued in the course of sale of individual parcels, as Mutual Savings disposes of foreclosed seaside property in Santa Barbara, California;

(2) directly made, fixed-rate house mortgages with short expected lives;

(3) indirectly made fixed-rate house mortgages with short expected lives, purchased in the open market in the form of mortgage-backed securities;

(4) a modest amount of directly made, long-term house mortgages with variable interest rates that fluctuate with the market up to 25% per annum;

(5) a substantial number of directly made, long-term, fixed-rate house mortgages given only to persons of low-to-moderate income, many in minority groups, who have good credit, reside within seven miles of Mutual Savings' office, and support Mutual Savings' loans with house equities amounting to at least 20% of house value, with the maximum size of mortgage permitted being about $191,000.

We will work hard to expand assets in category (5), covering small, long-term, fixed-rate house mortgages for local people of low-to-moderate income. Indeed this category is expected to cover a majority in number of all new directly made mortgages. We expect to impose no loan fees and to charge slightly below-market interest rates. Therefore, each new loan will cause an immediate economic loss, which will hit our earnings statement even before we sell the loans, as we plan to do. The loans will be

resold, not because they are inferior credit instruments, but because we do not wish to endure the asset-versus-liability maturity mismatch imposed by any long-term, fixed-rate mortgage.

FIRREA has increased pressure on both banks and associations to expand lending of the sort covered by category (5). As a result, in our area there can now be no lack of availability in this category of market-rate loans, meeting legislative objectives, for persons with good credit. Instead, all lenders face a shortage of qualified applicants. Given this shortage, as we now compete with bigger, better loan departments of larger institutions, the most efficient way to get our share of qualifying loans is to quote below-market interest rates and loan charges.

We do not resent making these loss-causing loans. We intend, with pleasure, to make more than our share, which we can well afford to do. We regret that we waited so long to compete vigorously for these loans and that we required regulatory prompting before we found a satisfactory solution of such simplicity. We were formerly brain-blocked, because (1) we didn't want to hold any long-term, fixed-rate loans, (2) we didn't want to impose on moderate-income borrowers the risks implicit in the only kind of variable-rate loan we were willing to make, (3) we had never routinely resold loans or deliberately loaned at a loss, and (4) we were preoccupied with avoiding calamitous results which came to many other savings and loan operators. Regulators, of course, have not demanded that we now lend at a loss. That aspect of our program is the result of our initiative alone.

We have had trouble attracting a significant volume of loans, with satisfactory characteristics, in category (4), covering our variable-rate loans which can escalate to bear interest rates of 25%. These loans have been in short supply despite our use of a very low interest rate spread (about 2 percentage points over the one-year U.S. Treasury rate). Moreover, while we have realized no losses on our variable-rate loans, we have encountered several collection delays, partly attributable to an incompetent policy decision of the Chairman. These two factors cause us to expect this category to shrink to minor significance.

Category (3), the short-term, fixed-rate, mortgage-backed security category, is a "last-resort" category for us. But it could eventually amount to a substantial percentage of assets, depending on what is available elsewhere.

As we select mortgage-backed securities, we will probably not be buying any complex instruments. Despite our love of comedy, we are going to avoid the newest form of "Jump Z tranches in REMICS." This refers to a particular contractual fraction — the "Z Form" — of a pool of mortgages, now subdivided by obliging issuers, advised by obliging investment bankers, into two new contractual fractions: (1) the "Sticky Jump Z" and (2) the "Non-Sticky Jump Z." At this rate, subdivision will soon get down to quarks.

We are deterred from buying such securities partly by our hatred of complexity. We also dread the prospect of state and federal examiners, none of whom has a Ph.D. in physics, reviewing, one after the other, our choices for soundness and billing us on a cost-plus basis to reflect value thus added. Some of the wonders of modern finance go on without us as we yearn for a lost age when most reasonable people could, with effort, understand what was going on.

In total, during the next few years, our policies will very likely cause our housing-related assets (exclusive of the one-time effect of development of our foreclosed seaside property) to continue to produce close to the lowest average gross return in the savings and loan industry. Incremental returns may not quite cover incremental interest and operating costs as we invest each new dollar of savings. It is quite conceivable that Mutual Savings will decline in size because it should decline in size.

Even so, we expect that Mutual Savings will muddle through in a manner satisfactory to Wesco shareholders with moderate expectations. Our optimism comes mainly (1) from an expected minor profit boost from disposition of our foreclosed seaside property and (2) from an expected major profit boost caused by ownership of our large holding of Freddie Mac stock. Both of these grounds for optimism are discussed below.

Mutual Savings has a buried value in a piece of foreclosed property: 22 seaside acres in Santa Barbara, acquired in 1966. By the time Mutual Savings started development (into 20 houses and 12 lots) in order to facilitate sale, the value of this property had appreciated by at least $12 million. The built-in appreciation will now be captured through development, assuming no large reverses caused by collapse of housing prices or unanticipated new regulatory troubles.

The first house is nearly finished, and about 15 houses are under construction. We expect to close sale of about half the parcels during the next year. There will be little or no profit added to built-in appreciation by the development process. Seaside land development, under present regulatory and market conditions in California, tends to be a no-profit activity — if you are lucky. It is full of queer happenings and closely resembles a Chevy Chase movie of extreme duration.

In 1988 Mutual Savings made a large and unusual purchase. It increased its holdings of Federal Home Loan Mortgage Corporation (widely known as "Freddie Mac") to 2,400,000 shares, 4% of total shares outstanding. Mutual Savings' average cost is $29.89 per share, compared to a price of $48.75 per share in trading on the New York Stock Exchange at the end of 1990. Thus, based on 1990 yearend trading prices, Mutual Savings had an unrealized pre-tax profit in Freddie Mac shares of about $45.3 million. At current tax rates the potential after-tax profit is about $26.7 million, or $3.75 per Wesco share outstanding.

Freddie Mac, created and long run by a federal agency (the Federal Home Loan Bank Board), is now owned privately, largely by institutional investors. It is now led by a very smart CEO, Leland Brendsel, and governed by an outstanding independent board of directors, including John B. McCoy of Banc One and Henry Kaufman, former chief economist of Salomon Brothers. 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 high percentage returns earned on equity capital in recent years. One ironic cause of the high returns is that this creation of federal regulators pays no deposit-insurance premiums as it replaces much of the former function of the savings and loan industry. Freddie Mac's high returns on equity are caused by a strong competitive position that is likely to last a long time. In its activities it faces only one other competitor of similar size, efficiency and reputation: Federal National Mortgage Association (widely known as "Fannie Mae"), a similar private corporation with governmental overtones.

At Freddie Mac's 1990 dividend rate ($1.60 per annum per share), Mutual Savings' pre-tax yield was only 5.35% on its $29.89 average cost per share. Post-tax, the dividend yield was only 4.4%, but this amounted to about 75% of the current after-tax yield from very high grade mortgages. Moreover, Freddie Mac has a creditable history of avoiding really hurtful loan losses and increasing its earnings and dividend rate, virtues that contribute to increases in the market price of its stock. Following are figures for 1985-1990:

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	12.12	28.2
1988	5.73	1.25	50.50	27.5
1989	7.28[1]	1.60	67.12	25.0
1990	6.90	1.60[2]	48.75	20.4

[1] restated

[2] raised to annualized rate of $2.00 per share on March 8, 1991

Despite Freddie Mac's strong competitive position, its stock declined in market value by 27% in 1990 (from $67.12 per share to $48.75 per share, in trading on the New York Stock Exchange). One reason for the decline was unanticipated losses from apartment house loans, particularly in New York and Atlanta. As a result, Freddie Mac wisely discontinued the most obviously dangerous part of its apartment house loan buying program. But it remains the guarantor or owner of some old loans (fortunately a small portion of total apartment house loans and a really tiny portion of total loans) that will create misery for years. It was probably ill-advised for Freddie Mac, given its position and financial leverage and the nation's needs, (1) ever to finance anything except owner-occupied, single-family, non-vacation houses, for which substantial down payments had been made by credit-worthy people, and (2) ever to deal with anyone other than mortgage originators and servicers of obvious integrity and

competence. Just as it is unwise for an individual to risk losing what he has and needs in an effort to gain what he doesn't have and doesn't need, it seems unwise for Freddie Mac to stretch its leveraged resources beyond purchase from obviously responsible people of carefully selected first mortgages on individual houses. Each lender, including the one writing this letter, seems destined to learn through painful, personal experience two obvious lessons from the past:

(1) The first chance you have to avoid a loss from a foolish loan is by refusing to make it; there is no second chance.

(2) As you occupy some high-profit niche in a competitive order, you must know how much of your present prosperity is caused by talents and momentum assuring success in new activities, and how much merely reflects the good fortune of being in your present niche.

In common experience, including ours, lesson (1) is eventually learned, but lesson (2) resists learning, despite high pain inflicted by multiple reverses.

As nearly as we can foretell, Freddie Mac's troubles with apartment house loans are endurable in scale and will no more significantly impair its long-term prospects than the salad oil swindle of 1963 impaired the long-term prospects of American Express. Moreover, the present managers and directors of Freddie Mac all seem to have absorbed a catechism appropriate for Freddie Mac and to be willing to endure political friction burns as necessary to keep operations sound. We like our large position.

Strangely, Mutual Savings' holdings of Freddie Mac, while lawful to own under FIRREA, (1) so far do not count as "housing-related assets" in the new 70%-of-assets test, and (2) must be written down, in stages, to a value of zero for regulatory accounting purposes. As these provisions start to bind, Mutual Savings will dispose of part of its Freddie Mac stock. One option is the transfer of stock to another Wesco subsidiary in return for cash.

What future in the savings and loan business do we expect? We don't know anything more than that we are satisfied at the moment with our temporizing strategy. We expect further changes, possibly radical, in the bank/savings-and-loan-association field, to which we will adapt as they unfold.

The present situation, with its many insolvent and almost-insolvent institutions, is such a mess that further legislation seems inevitable. We can predict neither the changes, nor whether the changes will make matters better or worse. But we do have some opinions. These opinions are almost totally out of step with current thinking in academia, among government officials, among banking executives and, most of all, among banking lobbyists. Despite this unconventionality, our opinions are now given to Wesco shareholders because they may provide some insight into our institutional nature and likely future action. We also hope, but only slightly, that the opinions, set forth below, will have a wider, civic utility.

First, let us turn to banking, after which we will consider the savings and loan business.

The sum of all deposit-insurance losses in banking will probably be much lower than the $200 billion or so recently caused by savings and loan associations. But there are a lot of very sick banks, and deposit-insurance losses are sure to be large. Moreover, even if there had been no such losses, there would be much to regret in the nature of our modern banks as they have increasingly emphasized lending for consumption (even lending at 20% for vacations in Tahiti) and lending to financial promoters and real estate developers. We have come a long way from an ideal emphasizing the banker's provision, to both big and small businesses, of what Pierre DuPont provided to General Motors. Plainly, we have a two-forked banking problem, with a questionable shift in priorities accompanying rising insolvencies.

Let us attempt to diagnose the causes of our problem. By and large, our problem did not come because banks couldn't branch across state lines, sell insurance, or underwrite corporate securities. Instead, it came because banks "reached" for higher yields on assets as they faced higher interest costs that came from (1) decontrol of interest rates paid by insured institutions plus (2) pressure from new competitors, including money-market funds possessing a large competitive edge.

Exactly how great is the money-market funds' competitive edge? To see, compare the average heavily regulated bank, paying high deposit-insurance premiums, with what has been created in an

extreme form of uninsured money-market fund. In the fiscal year ended June 30, 1990 one such $4 billion fund (The Common Fund for Short Term Investments) did all of the following:

(1) kept its assets in liquid short-term obligations of the U.S. government and other credit-worthy entities;

(2) furnished efficient checkwriting privileges and wire transfer service to its depositors;

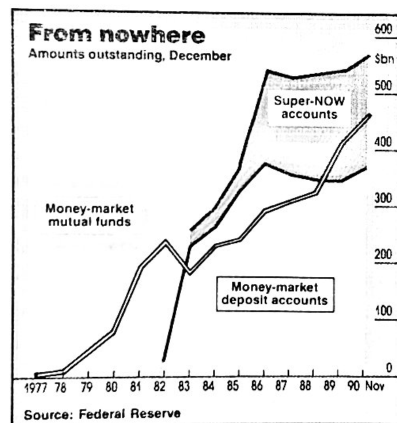
(3) kept its *total* operating costs under two-tenths of 1% of deposits per annum as it avoided costs of maintaining branch offices, deposit insurance, etc.;

(4) furnished no capital of its own as a cushion supporting promises to depositors; and

(5) paid very competitive rates on its interest-bearing accounts, as a result of which it grew 27% in size.

This example demonstrates the raw competitive power of keeping things simple. Indeed, in this example all costs combined have been controlled so as to be roughly equal to what the average local bank pays for federal deposit insurance alone! We are not dealing with some minor competitive advantage. The new competition is a juggernaut.

How important has the new competitor become? Naturally, the new competitor has taken a huge bite out of the market formerly served by banks (and savings and loan associations) burdened by much higher costs. How could it be otherwise? Here is a dramatic graph reprinted from what is surely among the best magazines in the world, England's *The Economist*:



The money-market funds are, in substance, "non-bank" banks, furnishing interest-bearing savings and checking accounts. And, by an odd stroke of good fortune, their light regulation by an overburdened SEC has turned out to be more advantageous than no regulation at all. The rules of the SEC force investment largely confined to reasonably safe and liquid categories. This has spawned simple operations with very low costs.

The simple, low-cost*, cream-the-market approach thus taken (or stumbled into) often works well in business. For instance, look at (1) GEICO, a hugely successful auto insurer almost 50% owned by Wesco's parent corporation or (2) various membership warehouse clubs, in the form invented by Sol Price, which are now clobbering retailing competitors as they get total "markup" under 10%. And this approach, as would be expected, is working like gangbusters for the money-market funds, as you see in the graph from *The Economist.*

What were the effects on banks as these new and successful, low-cost competitors took more and more of the market while, at the same time, each bank's banking competitors could bid as they wished

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* Total costs are low, even though they include fees containing a substantial profit element that are paid by the "non-bank" banks to the "non-independent" independent managing companies employed in conformity with mutual fund practice. While Lewis Carroll might have liked the consistency of the nomenclature just used, it is not clear that it befits a banking system. "Pretending" under misleading labels is not a good idea in banks. All "pretending" habits tend to spread.

for funds, using the government's credit? Well, naturally, almost every bank, being inherently saddled with much higher costs, and not wanting to go out of business, tried to get higher contractual interest rates on its loans. And this caused greater emphasis on loans for consumption and loans to financial promoters and real estate developers. Indeed, many of our most decisive bankers, quite logically, stopped trying to make loans to their most credit-worthy customers, accepting the disappearance of any important linkage between our best banks and our best businesses. The banks had been forced into an entirely different market niche (which already had some occupants): high-interest-rate lending.

And what can be expected when virtually all banks become specialists in high-interest-rate lending? It is hard to know for sure, because, throughout the past, high-interest-rate lending was hard to fund since it came from skeptical sources, instead of from government-insured deposits. Really large-scale, high-interest-rate lending is a comparatively recent phenomenon, made possible by governmental support in the form of deposit insurance used by banks with altered natures. But such experience as exists gives a likely answer: many bank insolvencies will come. Just as the simple, low-cost, cream-the-market strategy is a common business winner, the opposite strategy, involving high costs and high prices, is a common loser. High interest rate lending as a field has usually provided (1) some winners and (2) many casualties, often coming in bunches after periods of "follow-the-leader" asset-quality debasement. (Remember the widespread disasters in R.E.I.T. lending.) And the past bad experience should naturally worsen as the high-interest-rate lending field both expands and becomes overcrowded, driven by governmental support.

We are not alone in our diagnosis. Here is an excerpt from a recent *Wall Street Journal* editorial: "When more efficient, uninsured and less regulated financial institutions creamed off profitable lines of business, the [Bank of New England] was left concentrated in commercial real estate. This artificially diverted money into Boston's building boom, which inevitably became a bust."

Granting the presence of perverse incentives, what are the operating mechanics that cause widespread bad loans (where the higher interest rates do not adequately cover increased risk of loss) under our present system? After all, the bad lending, while it has a surface plausibility to bankers under cost pressure, is, by definition, not rational, at least for the lending banks and the wider civilization. How then does bad lending occur so often?

It occurs (partly) because there are predictable irrationalities among people as social animals. It is now pretty clear (in experimental social psychology) that people on the horns of a dilemma, which is where our system has placed our bankers, are extra likely to react unwisely to the example of other peoples' conduct, now widely called "social proof." So, once some banker has apparently (but not really) solved his cost-pressure problem by unwise lending, a considerable amount of imitative "crowd folly," relying on the "social proof," is the natural consequence. Additional massive irrational lending is caused by "reinforcement" of foolish behavior, caused by unwise accounting convention in a manner discussed later in this letter. It is hard to be wise when the messages which drive you are wrong messages provided by a mal-designed system.

In chemistry, if you mix items that explode in combination, you always get in trouble until you learn not to allow the mixture. So also, in the American banking system. To us, a lot of foolish, unproductive lending and many bank insolvencies are the natural consequences, given existing American banking culture, of the combination of the following two elements alone:

(1) virtually unlimited deposit insurance; and

(2) uncontrolled interest rates on insured deposits.

These two elements combine to create a Gresham's law effect, in which "bad lending tends to drive out good." Then, if factor (3) below is added to an already unsound combination, we think deposit-insurance troubles are sure to be further expanded — and not by a small amount:

(3) relatively unregulated, non-insured, low-cost "non-bank" banks.

Moreover, when the government starts suffering big deposit-insurance losses, if it continuously responds (in a natural, unthinking reaction) by raising deposit-insurance prices, we think it creates a "runaway-feedback" mode and makes its problems worse. This happens because the government, by adding even more cost pressure on banks, increases the cause of the troubles it is trying to cure. The price-raising "cure" is the equivalent of trying to extinguish a fire with kerosene.

Many eminent "experts" would not agree with our notions about systemic irresponsibility from combining (1) "free-market" pricing of interest rates with (2) government guarantees of payment. If many eminent "experts" are wrong, how could this happen? Our explanation is that the "experts" are over-charmed with an admirable, powerful, predictive model, coming down from Adam Smith. Those discretionary interest rates on deposits have a "free-market" image, making it easy to conclude, automatically, that the discretionary rates, like other free-market processes, must be good. Indeed, they are appraised as remaining good even when combined with governmental deposit insurance, a radical non-free-market element.

Such illogical thinking displays the standard folly bedeviling the "expert" role in any soft science: one tends to use only models from one's own segment of a discipline, ignoring or underweighing others. Furthermore, the more powerful and useful is any model, the more error it tends to produce through overconfident misuse.

This brings to mind Ben Graham's paradoxical observation that good ideas cause more investment mischief than bad ideas. He had it right. It is so easy for us all to push a really good idea to wretched excess, as in the case of the Florida land bubble or the "nifty fifty" corporate stocks. Then mix in a little "social proof" (from other experts), and brains (including ours) often turn to mush. It would be nice if great old models never tricked us, but, alas, "some dreams are not to be." Even Einstein got tricked in his later years.

We may be right or wrong. But, if we are right, if there are deep, structural faults in the American banking system, it follows that merely giving banks the right to branch across state lines, to sell insurance, or to enter investment banking (or all of the above) is not going to end our troubles.

Instead, a good long-term fix can come only after the government considers more extreme modifications in the system, each of which has powerful, vocal opponents. What are the more extreme modifications to consider? We think the list includes:

(1) greatly reducing deposit insurance;

(2) eliminating money-market funds;

(3) bringing back some form of controls on interest paid on insured deposits;

(4) intensifying regulatory control of bank lending in an attempt to reduce loan losses;

(5) forcing more conservative accounting covering bank lending;

(6) forcing weak banks into other hands before the weak banks become insolvent; and

(7) forcing insolvent banks into competing local banks, or entirely out of business, instead of into strong, out-of-state banks.

Let us next attempt a brief discussion of the merits and/or political prospects of each of these seven governmental options.

Option (1): greatly reducing deposit insurance:

To many people, remembering former banking panics, this option, adopted fully, seems like trying to solve the overcrowding problem by bringing back cholera. Accordingly, proponents of this option typically would limit its effects by (1) bringing back bank "runs" only for small banks (big banks, regardless of law, are "too big to fail" in all advanced countries) and (2) bringing back deposit losses only to some rich depositors. Because voters don't like bank "runs" of any size, and small banks don't like discrimination, it seems unlikely that reductions in deposit insurance are going to be made on a scale that solves the structural defect problem. Conceivably, "brokered" deposits could be removed from insurance coverage, in a move driven by legislative remembrance of many abuses involving stockbroker-assisted financing of despicable insured institutions. (Many stockbrokers could easily see that the insured certificates of deposit they were paid to sell were issued by institutions managed by knaves and fools, presiding over piles of junk loans and junk securities. The stockbrokers thus knew, or should have known, that their government was being robbed. To sell certificates under such conditions was a lot like finding currency in a post office bag and deciding it was ethical to keep it.)

Option (2): eliminating the money-market funds:

This option is almost never discussed. This seems peculiar. The money-market funds came into being without public policy input when some clever person combined (1) mutual fund status under the S.E.C. with (2) purchase, under subcontract, of services from a bank. What was created was, in essence, a virtually unregulated, uninsured bank furnishing interest-bearing savings and checking accounts. The creation of such entities would probably not have been authorized if new legislation had been necessary. Where else do we have virtually identical regulated and unregulated entities operating on the same scale, side by side? If new legislation had been needed, the following questions might have been raised:

(1) What do money-market funds do for "community" lending, lifeline services to the elderly, etc.?

(2) Are they fair to existing institutions?

(3) Won't the new "non-bank" banks make it harder for the Federal Reserve System to render constructive economic service?

(4) Since the public is already on the hook as guarantor of solvency of existing institutions, is it wise for the guarantor to risk losses from allowing uninsured, cream-the-market, more efficient operators to add to the competition? (This question would not be hard to answer in a private setting. If you were guarantor of all obligations of your brother-in-law's hamburger joint, you would consider it very foolish to allow McDonald's to commence operations by his side when you possessed the ability to prevent it.)

(5) Considering all of the above (and more), are the money-market funds in the long-term interest of the soundness and service of the total banking system?

These questions are still good questions. But possession is strength under law. The money-market genie is now out of the bottle. And, considering his size, it would be hard to put him back. The prospects of rebottling are plainly remote.

Option (3): bringing back some form of controls on interest paid on insured deposits:

This option, too, is now seldom discussed. Again, this seems peculiar. It is among the first things you or I would consider if we had to guarantee all obligations of that hamburger joint owned by a brother-in-law. We would no more guarantee an 11% obligation for him, when we could easily borrow at 8%, than we would burn currency in the fireplace. In fact, we would suspect dishonorable "monkey business" if an 11% transaction occurred.

One reason for present lack of legislative interest in interest-rate controls lies in the knowledge that a former version of such controls constricted housing credit when interest rates rose to high levels. No one now seems interested in trying to develop new controls, more flexible in form and practice, that would avoid former defects. Nor is anyone much interested in the success the Japanese (or the United States) had during a long period of control of interest rates paid by banks. The interest-rate-control option, at the moment, seems dead.

Option (4): intensifying regulatory control of bank lending in an attempt to reduce loan losses:

This option is already being exercised — erratically — with effects both good and bad. It certainly has successful counterparts in non-banking businesses. For instance, take McDonald's franchised restaurants. If you want to use the McDonald's authenticating name and arches on your restaurant, you have to operate in a very limited, foolproof way. Moreover, the McDonald's approach once worked in banking. When deposit insurance first came in, and long thereafter, most insured banks operated in simple, sound fashion, often through ill-paid employees. But, based on all recent precedents, the government won't now act like McDonald's, or itself in a former era. (If it wished to do that, it might now give deposit insurance to all the simple, sound money-market funds, lending to big business through purchases of commercial paper, and take deposit insurance away from all the banks and savings and loan associations!) Government, instead, will probably take the more limited approach of concurrently: (1) leaving banking over-stressed by competition, (2) leaving banking very complicated, (3) trying to prevent problems by writing massive, hard-to-understand regulations that create more work for lawyers, and then (4) monitoring bank operations through overburdened civil servants. These limited remedies may be better than nothing, but their prospects for causing a real banking fix seem poor. It is almost a

general rule of American life that, when incentives are all wrong, controls (even criminal-law controls) can't fix our troubles. We can expect limited good effects from Option 4 and the continuation of important, basic problems.

Option (5): forcing more conservative accounting covering bank lending:

Bank accounting is a hot current topic, but conservatism is not the goal. Everyone is wondering how much to delay loan write-offs, when loans go sour, so as not to over-correct weak banks. We are not going to enter the lists on that problem.

The almost-never-discussed problem that interests us is that presented by newly made loans, bearing high interest rates, that under current bank accounting tend to be treated as "born good." The result is that all interest accrued, and sometimes some up-front fees, are treated as fully earned, even though the final outcome of the whole loan transaction is far from clear. To us, this is counterproductive accounting, even though we use it ourselves when pushed by convention.

We think current accounting for many high-interest-rate loans has terrible consequences in the banking system. In essence, it "front ends" into reported income revenues that would have been deferred until much later, after risky bets were more clearly won, if more conservative accounting had been employed. This practice turns many a banker into a human version of one of B. F. Skinner's pigeons, since he is "reinforced" into continuing and expanding bad lending through the pleasure of seeing good figures in the short term. The good figures substitute nicely in the mind for nonexistent underlying institutional good, partly through the process, originally demonstrated by Pavlov, wherein we respond to a mere association because it has usually portended a reality that would make the response correct.

Under prevailing accounting, banks now ordinarily report increases in both earnings and equity capital during any transition they make toward less conservative lending. And then, if more lending of that type is done, and is accompanied by growth in institutional size, good reported figures will continue for an additional period. If an increase in institutional size is deemed necessary, it is, of course, assured by the bank's access to the government's credit through deposit insurance.

We think acculturated corporate nature, in American financial institutions, simply cannot, on average, handle temptations implicit in this sort of accounting. Indeed, the succumbing to the temptations, in a manner not consistent with long-term institutional interest, often occurs through a subconscious process. The subconscious process includes bad effects from both (1) "social proof," and (2) a "reality-denial" mode that creates bias in people stimulated, honored and paid in proportion to institutional size. Under our present system a Columbia Savings, and many less obscene versions of its model, are almost inevitable.

Of course, a large minority, even a majority, of bankers will remain sound, despite the temptations. But this outcome is not sufficient to protect the deposit insurer from unacceptable ultimate losses. In due course, given present conditions, the deposit insurer will suffer from what some wag called the problem of there being so many more banks than bankers.

What should now be considered are mandatory accounting changes, including changes in accounting to shareholders, designed to force "back-ending" into reported income of revenue from various types of gamy lending (and letters of credit), in lieu of allowing "front-ending" to continue. The changes would cause American bank accounting, by fiat, to imitate what some of the best European bankers have long done by choice. Eventually, credibility might be returned to banks' audited financial statements, now often regarded as fairy tales.

Despite the obvious (to us) accounting defects that bedevil our system, we don't think any wise and important accounting changes will be made. Typical bank reaction to such proposals is, at best, that of the man who asked, well before his ultimate sainthood: "God, give me chastity, but not yet." Also, time periods for accomplishing even the simplest, "no-brainer" changes in accounting convention tend to stretch into years.

Option (6): forcing weak banks into other hands before the weak banks become insolvent:

This option is also a hot topic. Usual governmental practice at the moment is to force merger only when all shareholders' equity is gone and the deposit insurer has a large loss. This is "bonkers," due process gone mad. It seems entirely logical now to commence the forced merger or closure of many of the nation's 13,000 banks and to do it in many cases before a weak bank is insolvent. Because the need

is so obvious, laws and customs may possibly change to cause more of this to happen. And interstate branching may be allowed in order to enlarge the number of potential bank buyers.

While these steps seem helpful, they won't fix the problem of deep structural fault in the system— at least within any acceptable time period. Look at the present carnage in airlines. Even when we are down to fewer than a dozen significant operators, messy airline failures continue. If we wait for an airline-style solution in banking, we will have to endure years, maybe decades, of suffering.

Option (7): forcing insolvent banks into competing local banks, or entirely out of business, instead of into strong out-of-state banks:

According to Martin Mayer, writing recently in *The Wall Street Journal*, the FDIC now typically deals with an insolvent bank by choosing between two options:

(1) forcing the insolvent bank into a competing local bank, or entirely out of business, thus dampening local competition; or

(2) first, replacing all the insolvent bank's bad assets with good assets, and, second, selling it to some skillful out-of-state buyer, after which process the new bank can help clobber the remaining also-weak-and-also-insured banks in the area.

Mayer believes it was "insane" for the FDIC to do as it did in many instances, which was to select option (2). According to Mayer, the FDIC thus arranged that "overcapacity was rigorously maintained." Mayer raises an interesting question. Coming back to the analogy earlier used, if you or I were really unlucky and were guarantor for seven local brothers-in-law, each with a troubled hamburger joint, what would we do when the first one went broke? We would surely reject the idea of, first, fixing up the defunct joint so that it was better than the others, and, second, guaranteeing the obligations of a new and more skillful out-of-state operator who wanted to enter the market by taking over the improved facility.

Mayer is right insofar as he implies that there are too many banks and bank branches, just as there were formerly too many filling stations, sometimes three or four at an intersection. The departed filling stations "never will be missed," so perhaps the FDIC should "have a little list," like the bloodthirsty figure in the Mikado.

Beyond that, we are not certain that Mayer's conclusions will always prove right. The basic banking system is right out of *Alice in Wonderland*, so maybe it's like non-Euclidean geometry and only *Alice-in-Wonderland*-type cures really fit in. After all, the scenario which troubles Mayer has a perverse beauty, at least to a government. The bank failures cascade, on and on, refreshed by new governmental acts, so that the FDIC can be saving a large part of the banking system each year for a long time.

And we must admit that, if we were the FDIC and were thus forced to participate heavily in our present banking system, like it or not, we would occasionally do what Mayer finds objectionable, in those rare cases when we saw a chance for greatly improving banking culture in some community. We would, for instance, occasionally sell a sick bank to John McCoy (of Banc One), even when this brought a new bank to a state full of troubled banks, if every in-state bank seemed too weak or foolish to be selected as an alternative buyer. We would figure that (1) some subsequent insolvencies of other local banks were in our long-term interest, (2) we were supporting a sound model, and (3) eventually, as the example spread, our troubles as deposit-insurer of a silly system would be reduced. We would then have a pleasant lull before the silly system caused new troubles to pop up, maybe even under McCoy's successors at Banc One.

While Mayer's subject is interesting, we probably don't have to worry much about worldly consequences. Outside science, it is amazing how little impact there can be from a powerful idea, published in a prominent place (such as the *Journal*). Everyone's experience is that you teach only what a reader almost knows, and that seldom.

If our foregoing comments about systemic irresponsibility and chances for a rational cure are right, or substantially right, it is hard to be optimistic about coming legislative "reform" of banking. Perhaps the best we can hope for is Menckenian reform where old error is replaced, not by truth, but by new error. It is also possible that we will see exactly the same old systemic error repeated, but bearing bells

and whistles in the form of new bank powers. This outcome is roughly what is recommended by the banking lobby, which has evidently learned nothing from the history of the savings and loan laws.

Let us next turn to the savings and loan field. Here, faced with a more disastrous mess, the legislators were so outraged that they attempted what they thought was extreme reform: FIRREA. This legislation took a "back-to-basics" approach and has since been interpreted by regulators who seem to believe, understandably, that they must act as though they were tough "bouncers," given the job of bringing order to a drunken brawl (a description that understates what the regulators faced).

This regulatory approach is now squeezing out (1) much folly, and (2) some non-folly needed to keep institutions healthy. Most executives we know at other associations concentrate only on the negative side and are outraged at instances of regulatory elimination of non-folly. They tend to construe present FIRREA enforcement as the equivalent of Mark Twain's prescription for preventing children's stuttering: "Remove the lower jaw."

Our view is different, even though we are much harmed by FIRREA. We think the system needed new rules, interpreted by tough "bouncers," and that the "bouncing" process, done with sufficient vigor, inevitably involves some lumps for the undeserving. There may even be some deaths from "friendly fire." Nonetheless, the process must go on.

What concerns us is the most important question of all. Did our legislators, through FIRREA, even with their "never again" mindset, fix the most important systemic error in the savings and loan industry? We think not.

As the dust has cleared, the best savings and loan associations are clearly worse businesses than the best banks (which themselves have plenty of troubles). This conclusion is supported by both (1) stock market prices and (2) action of governmental liquidators in response to market conditions. Stocks of the best associations now sell at much lower price/book-value ratios than stocks of the best banks. And governmental liquidators are constantly selling association branches to banks while almost never selling bank branches to associations. FIRREA has not made associations, on average, as desirable for owners as banks. The two institutional types remain different and unequal, while quite comparable in essential residual function, now that Fannie Mae and Freddie Mac exist to perform a lion's share of the finance function supporting housing.

The savings and loan system, in a modern era in which the government is always a large net borrower, still tries to use short-term savings accounts to finance long-term housing lending. This is, in essence, a very bad idea, violating the logic of an elementary prescription: "If a thing isn't worth doing at all, it isn't worth doing well."

To be sure, some fix of systemic maturity-mismatch risk is now attempted, through encouragement of variable-rate loans. But the variable-rate loans typically "cap" interest rate escalation at a few percentage points, which must be done for moderate-income borrowers to prevent both (1) unacceptable hardship and (2) sudden falls in non-housing spending. This compromise is like having building codes in California protect only up to 5 points on the Richter earthquake scale. The compromise is almost sure to bring back, probably at a remote date, another horrible collapse of the savings and loan system.

As we say this, we are not critical of the best California associations, such as Home Savings, Great Western Savings and World Savings. These people have logical operations bearing one big systemic risk that cannot be avoided by permanent players. If we had to play forever under current rules, we would try to imitate them. But we would have a big disadvantage: "we don't know how to get there from here," because they have such momentum in systems, particularly in loan origination. Fortunately, no one is sentencing us to play forever in a game with a systemic risk we don't like and in which we are at a big disadvantage. Instead, we have temporized with a different, acceptable "there" in a form combining (1) a big holding of Freddie Mac, with (2) financial flexibility to adapt as we choose to new conditions.

So much for ridicule, pessimistic speculations, and excuses for our defects, always easy to provide. As any responsible calamity-howler should, we will now risk playing the fool in public by attempting to say what we would do with the bank/money-market fund/savings and loan system if we were Congress:

(1) Because we have a help-housing bias, we would keep government-assisted housing finance for low-to-moderate-income people. We would do this by forcing pension funds to maintain a significant portion of their assets in housing-related assets in the form of Freddie Mac and Fannie Mae mortgage-backed securities representing interests in fixed-rate mortgages. This

requirement strikes us as fair, given the tax exemption possessed by the pension funds. And the pension funds are the logical suppliers of housing finance because they by nature have (a) massive assets, and (b) liabilities with maturities matching homeowners' needs for long-term, fixed-rate credit. Our reason for specifying Freddie Mac and Fannie Mae securities as a conduit for housing assistance is our belief that these entities would assure loan quality better and more cheaply than would any government bureaucracy. In quantitative terms, we would leave housing finance more assisted than it is now, particularly for first-time home buyers who have won their spurs.

(2) We would merge the banks, money-market funds and savings and loan associations into one banking system, with insured deposits. The new banking system would be separate from both (a) industry and (b) the part of investment banking likely to disappoint investors. It would have the following characteristics:

(i) There would be one federal regulator that also served as deposit-insurer, in lieu of the truly crazy, inefficient Balkanization of our present regulatory and insurance apparatus. (Eliminating Balkanization would do more than reduce costs, delays, confusion and competition in laxity. There is a system-design advantage in making the deposit-insurance loss payer and the bank-controlling loss preventer one and the same. The system then becomes more "responsible" in the Frankelian sense, requiring that systems be organized, to the extent feasible, so that decision-makers, not others, bear consequences of decisions.)

(ii) There would be no bank-holding companies, but the new banks would have a monopoly in offering check-writing privileges, debit cards and credit cards, except for credit cards offered on behalf of a single vendor. (The new law would permit tax-free spinoffs of existing banks, newly organized banks, and non-banks to help existing corporations come into compliance. Spun-off non-banks could include specialists in high-interest-rate lending to businesses.)

(iii) Flexible, government-regulator-run controls would set a ceiling on interest that could be paid on bank accounts. (If you are going to guarantee the credit of an entire industry, there is a limit to the competition that is desirable. Besides, many banks will behave badly in their important function when they are under the extreme cost pressure, not normal in business, that occurs when one's competitors are all financed without limit by the government, through deposit insurance.)

(iv) All capital satisfying regulatory requirements would have to be in the form of stock, either common or preferred, except for "grandfathered" debt.

(v) Stockbrokers (and others) could buy for customers all the insured certificates of deposit they wished, but they could not, in exchange, receive commissions or other advantages from the banks issuing the certificates. ("Abuse it and lose it," is our motto.)

(vi) The federal regulator would have clear power, exercisable without an excess of "due process" or "second guessing," to close out or force sale or merger of weak banks well before they became insolvent. Banks could ordinarily avoid such calamities, after a first warning, by raising new capital through "rights" issues, or in some other way. (There is nothing novel in such a system. Close-out orders, issued well short of insolvency, have long been standard practice under regulatory practice governing securities and currency traders.)

(vii) Bank accounting for all purposes would count much revenue as profit only after all significant risk had been removed from the transactions generating the revenues. Bank dividends, of course, could be paid only from the more conservatively reported profits. Income tax would be deferred on the deferred revenues required by this new conservatism in accounting. (It is a terrible mistake, a novice's mistake, to try to control important behavior with an all-stick-and-no-carrot approach. Therefore, the carrot-providing tax deferment would be wise.)

(viii) There would be no 2,000-page mass of government regulations. But there would be some rule for business and real estate loans such as: loan as you wish, but no new loans count as bank assets unless supported by substantial equity, a stipulation that would create a large margin of safety.

(ix) Deposit-insurance rates would promptly be lowered from present levels, but under a new system so tough that risk of loss to the deposit insurer would be reduced, even after taking into account the effects from lower rates.

(x) The whole system would be designed to have the best businesses, small and large, again become intimate with the best banks. The banks would again concentrate on being (1) relatively low-interest-rate lenders to high-quality businesses, and (2) lenders to consumers who are not "fiscaholics". High-interest-rate lending, to people with weak credit, would be forced into non-banking systems retaining no common-management or common-premises links with banking.

There is, no doubt, much wrong with our recommendations. But there is also much wrong with our present system, which has helped cause a questionable shift in banking priorities and a big mess, with every prospect for more of the same. In contrast, there is little in history to suggest that our recommendations would be as bad. And even if the new system had serious faults, it would probably be a better way station on the path to a banking system befitting a great country.

In recent years the government has tried to maintain a useful, relatively trouble-free banking system by making the banking business bear increased competitive burdens, and, when the system has responded by working worse, the government has increased both the burdens and the permitted scope of banks' activities. After such revisions the system has again worked worse. Surely it is time to reverse our approach. We should act like the artillery officer who, when he has put one shell over the target, next tries to put a shell clearly short, expecting to get the desired result in due course.

Some people might worry that banking would get too profitable under the system we recommend. To this worry there are three answers:

(1) The prospect of better profits, with less risk, would tend to (a) reduce governmental losses as many billions of dollars worth of foreclosed thrift and bank assets are sold off by the FDIC, and (b) enable the government, through tough capital standards, to cause eager private augmentation of banking capital by shareholders, precisely what is needed.

(2) Based on past experience, the nation's bankers (including us) may, on average, be up to the challenge of not earning excessive profits, even in an easier system.

(3) If excessive profits came, they could easily be reduced in due course by a new governmental tax, charge or burden.

We now quitclaim legislative reform to those who make it their business. We also assure Wesco shareholders that this reform-minded section of our letter to shareholders is an unlikely-to-be-repeated aberration. It was caused, in part, by a combination of (1) overwhelming disgust with the present scene, and (2) long association by the writer with an eccentric fellow who may not share all the notions herein expressed but who encourages this kind of writing.

This eccentric, who heads Berkshire Hathaway, Wesco's parent corporation, believes for some reason that accumulated wealth should *never* be spent on oneself or one's family, but instead should merely serve, before it is given to charity, as an example of a certain approach to life and as a didactic platform. These uses, plus use in building the platform higher, are considered the only honorable ones not only during life but also after death. Shareholders who continue in such peculiar company are hereby warned by our example in writing this section: some of the eccentricities of this fellow are contagious, at least if association is long continued.

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, 1990 by about $46 million, down significantly from about $98 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 $61.3 million. As earlier emphasized, about $56.2 million of this unrealized appreciation lies within the savings and loan subsidiary and includes $45.3 million of appreciation in stock of Freddie Mac.

The foregoing paragraph deals only with unrealized appreciation of securities above "carrying value." Wesco also has some unrealized appreciation in securities that is already in "carrying value." This has happened because Wesco's insurance subsidiary at December 31, 1990 had about $40.9 million in appreciation in common stocks (mostly stock of The Coca-Cola Company). Under a peculiar accounting convention applicable only to insurance companies, this appreciation, minus the income taxes that would be due if the stocks were sold, is already included in Wesco's audited net worth, even though the gain has never passed through any audited report of income.

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, we seek to better understand the few decisions we make.*

Wesco's Pasadena real estate comprises 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, which it would probably be wiser to destroy than improve. This real estate has a market value substantially in excess of carrying value. The existence of unrealized appreciation is demonstrated by (1) mortgage debt ($4,524,000 at 9.25% fixed) against this real estate exceeding its depreciated carrying value ($3,163,000) in Wesco's balance sheet at December 31, 1990, 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

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* It is interesting to compare Wesco's approach (deliberate non-diversification of investments in an attempt to be more skillful per transaction) with an approach promoted for years by Michael Milken to help sell junk bonds. The Milken approach, supported by theories of many finance professors, argued that (1) market prices were efficient in a world where investors get paid extra for enduring volatility (wide swings in outcomes); (2) therefore, the prices at which new issues of junk bonds came to market were fair in a probabilistic sense (meaning that the high promised interest rates covered increased statistical expectancy of loss) and also provided some premium return to cover volatility exposure; and (3) therefore, if a savings and loan association (or other institution) arranged diversification, say, by buying, without much examination, a large part of each new Milken issue of junk bonds, the association would work itself into the sure to-get-better-than-average-results position of a gambling house proprietor with a "house" edge. This type of theorizing has now wreaked havoc at institutions, governed by true-believers, which backed their conclusions by buying Milken's "bonds." Contrary to the theorizing, widely diversified purchases of such "bonds" have in most cases produced dismal results. We can all understand why Milken behaved as he did and believed what he had to believe in order to maintain an endurable self-image. But how can we explain why anyone else believed that Milken was paid 5% commissions to put "bond" buyers in the position of the house in Las Vegas? We suggest this cause: many of the foolish buyers, and their advisers, were trained by finance professors who pushed beloved models (efficient market theory and modern portfolio theory) way too far, while they ignored other models that would have warned of danger. This is a common type of "expert" error, as we have earlier indicated.

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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 not in 1991 and 1992. The next two years are not likely to be good years for most owners of commercial real estate.

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 values its AA+ credit rating.

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 requires patience, at least for people like us.

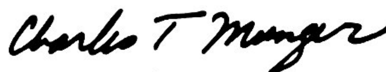
The ratio of Wesco's annual reported consolidated net income to reported consolidated shareholders' equity, about 12% in 1988-90, was dependent to a significant extent on securities gains, irregular by nature.

When Berkshire Hathaway bought into Wesco in 1973, the present stock (adjusted for a later three-for-one split) traded at about $6. At yearend 1990, the stock traded at $47⅞ and it has paid modest dividends, increased every year, during Berkshire Hathaway's stewardship.

The financial results for Wesco shareholders have not been bad. But they are not outstanding, considering the power of compound interest and the generally favorable business climate. And now, after all these years, Wesco continues to have (1) a *very* strong balance sheet, and (2) a shortage of direct ownership of businesses with enough commercial advantage in place to assure permanent high future returns on capital employed. In contrast, the parent company, Berkshire Hathaway, is better positioned. This outcome was explained in Wesco's annual report last year, to which we refer Wesco shareholders, new and old.

On January 24, 1991, Wesco increased its regular quarterly dividend from 20½ cents per share to 21½ cents per share, payable March 12, 1991, to shareholders of record as of the close of business on February 28, 1991.

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
Chairman of the Board

March 8, 1991

BERKSHIRE HATHAWAY INC.

Selected Financial Data for the Past Five Years
(dollars in thousands, except per share data)

	1986	1987	1988	1989	1990
Revenues:					
Sales and service revenues	$1,219,252	$1,326,829	$1,407,642	$1,526,459	$ 1,580,074
Insurance premiums earned	823,884	824,895	584,235	394,279	591,540
Interest and dividend income	181,992	237,319	314,251	331,452	450,295
Realized investment gain	220,764	28,838	131,671	223,810	33,989
Sundry	6,316	13,901	27,094	7,892	3,574
Total revenues	$2,452,208	$2,431,782	$2,464,893	$2,483,892	$ 2,659,472
Earnings:					
Before realized investment gain	$ 131,464	$ 214,746	$ 313,441	$ 299,902	$ 370,745
Realized investment gain	150,897	19,806	85,829	147,575	23,348
Net earnings	$ 282,361	$ 234,552	$ 399,270	$ 447,477	$ 394,093
Earnings per share:					
Before realized investment gain	$ 114.62	$ 187.24	$ 273.37	$ 262.46	$ 323.39
Realized investment gain	131.57	17.27	74.86	127.55	20.36
Net earnings	$ 246.19	$ 204.51	$ 348.23	$ 390.01	$ 343.75
Year-end data:					
Total assets	$4,931,354	$5,863,235	$6,816,848	$9,459,594	$10,670,423
Term debt and other borrowings	260,170	289,886	480,009	1,007,516	1,239,358
Shareholders' equity	2,377,797	2,841,659	3,410,108	4,925,126	5,287,454
Common shares outstanding, in thousands	1,147	1,147	1,146	1,146	1,146
Shareholders' equity per outstanding share	$ 2,073	$ 2,477	$ 2,975	$ 4,296	$ 4,612

COMMON STOCK

Stock Transfer Agent

The Bank of Boston Shareholder Services Division, P.O. Box 644, Boston, MA 02102 serves as Transfer Agent and Registrar for the Company's common stock. Correspondence with the Division may be directed to Customer Service Section, Mail Stop 45-02-09. Certificates for re-issue or transfer should be directed to the Transfer Processing Section, Mail Stop 45-0105. **Certificates should not be mailed to the Company.**

Shareholders

The Company had approximately 6,800 record holders of its common stock at March 4, 1991. Record owners included nominees holding at least 153,000 shares on behalf of beneficial-but-not-of-record owners. Management believes that the Company has more than 14,000 beneficial owners.

Price Range of Common Stock

The Company's Common Stock is listed for trading on the New York Stock Exchange, trading symbol: BRK. The following table sets forth the high and low sales prices per share, as reported on the New York Stock Exchange Composite List, during the periods indicated:

1990	High	Low
First Quarter	$8,725	$6,675
Second Quarter	7,675	6,600
Third Quarter	7,325	5,550
Fourth Quarter	6,900	5,500

1989	High	Low
First Quarter	$5,025	$4,625
Second Quarter	7,000	4,950
Third Quarter	8,750	6,600
Fourth Quarter	8,900	7,950

Dividends

Berkshire has not declared a cash dividend since 1967.

BERKSHIRE HATHAWAY INC.

DIRECTORS

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

CHARLES T. MUNGER, *Vice Chairman*
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

MALCOLM 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 and packaging.

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*
MARC D. HAMBURG, *Treasurer*
DANIEL J. JAKSICH, *Controller*

ROBERT M. FITZSIMMONS,
Director of Internal Auditing

JERRY W. HUFTON,
Director of Taxes

J. WILLIAM SCOTT,
Director of Financial Assets

Two compilations of letters from earlier Annual Reports are available upon request. One is from reports for 1977 through 1983, the other, from reports for 1984 through 1988. Single copies are furnished without charge in response to requests received by the Company at 3555 Farnam St., Suite 1440, Omaha, NE 68131.

BERKSHIRE HATHAWAY INC.
Executive Offices — 1440 Kiewit Plaza, Omaha, Nebraska 68131