Commentary
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"I am a better investor because I am businessman, and a better businessman because I am an investor." – Warren Buffett

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Accounting Adventures: Behind Berkshire's 2015 Kraft Heinz Gain & 2011 Wells Fargo Write-Down

Among the many joys of keeping up with Berkshire Hathaway is learning new things about accounting. One recent example came from the company's Third Quarter 2015 10Q filing when it recorded a $6.8 billion pre-tax, non-cash gain on its stake in the Kraft Heinz Company. Another, less-recent, example was Berkshire's 2011 non-cash write-down of part of its stake in Wells Fargo, despite the investment as a whole being profitable. These are the types of adjustments and charges that create the work for investors to decode, and to decide whether they are simply accounting-based maneuvers, or representative of economic reality.

Kraft Heinz

In June 2013 Berkshire Hathaway, along with 3G Capital, purchased the Heinz Company for approximately $28.75 billion in cash, taking equal ownership stakes in a newly formed holding company, Heinz Holdings. To help fund the buyout Berkshire and 3G each invested $4.25 billion in common equity and Berkshire also put in cash in the form of $8 billion worth of 9% cumulative compounding preferred stock. With the latter Berkshire also received warrants that allowed it to purchase additional common shares (this will be important later). The remainder of the purchase price was funded with debt. Then, in March 2015, Heinz Holdings offered to merge with Kraft Foods, to which the latter's shareholders ultimately agreed. Just prior to the July 2015 closing Berkshire exercised its warrants to purchase approximately 46 million shares of Heinz Holdings at $0.01 per share, bringing its ownership interest to approximately 52.5%. Berkshire and 3G then contributed an additional $10 billion, pro-rata, to Heinz Holdings, which funded the cash portion of the Kraft buyout (consideration was partly in cash and part future ownership – 49% in total – of Kraft Heinz). Kraft was merged into Heinz Holdings and Heinz Holdings immediately changed its name to Kraft Heinz Company. The final step in the merger was the issuance of new shares to the former Kraft shareholders, which reduced Berkshire's investment by roughly half, to 26.8% (3G's equity was also reduced). Berkshire now owned a smaller portion of a larger, more valuable company. However, because it reduced its ownership, by accounting rules it technically had sold a portion of its investment, and therefore was required to book a gain. Importantly, because no actual sale had taken place, there were no tax consequences as a result of the transaction.

The Accounting: So what was going on here? Under GAAP rules there are three methods of accounting for equity ownership. Ownership of up to 20% is accounted for under the cost method. The investment is booked at cost and is not altered unless an additional investment is made, a permanent impairment is recognized, or it is sold. Any dividends are treated as income. Between 20% and 50% an investment is generally accounted for under the equity method. This is the accounting principle at work above. Under this method of accounting the investment is recorded at cost, same as the cost method, however, any earnings (or losses) are added to (subtracted from) the carrying value of the investment. Any dividends do not count as income to the holder of the investment but do reduce the carrying value. The last method is consolidation. Above 50% an owner is generally considered to have control of the investee and will consolidate its books with the parent company. The accounting here is just like any other subsidiary. Assets, liabilities, and equity show up on the balance sheet, and the portion of equity not owned by the majority owner is accounted for under 'minority interests' under the equity section. Similarly, any revenues, expenses, and profit/loss is accounted for on the income statement of the majority owner. Any profit or loss due the minority owners shows up as a separate line item. To return to Berkshire, when shares in the new Kraft Heinz entity were issued to the former Kraft shareholders, Berkshire was deemed to have "sold" approximately 25.7% of its ownership interest. The result was a pre-tax gain of approximately $6.8 billion, and an after-tax gain of $4.4 billion. Again, because no actual sale took place, no tax bill was due to Uncle Sam.

Wells Fargo

Berkshire Hathaway has continuously owned shares in Wells Fargo for almost 30 years. It first began acquiring shares in 1989 and has added to its investment on numerous occasions. At last count, at the end of the third-quarter 2015, Berkshire owned over 470 million shares valued at over $25 billion. Not surprisingly many of the shares purchased in early periods are worth considerably more today than their original cost.

In December 2010 the Securities and Exchange Commission sent Berkshire a letter asking it to explain why Berkshire had not written down a block of 103.6 million shares of Wells Fargo stock it held that was under water by $920 million at September 30, 2010. The SEC was concerned that the Wells Fargo shares had remained in a "gross unrealized loss position" for almost two years (21 months). This was despite the fact that at no time had Berkshire's aggregate investment in Wells Fargo gone underwater. As the table below clearly shows, even in 2009, at the depths of the bear market, Berkshire still had an unrealized gain of over $1.6 billion on its Wells Fargo investment.

	2006	2007	2008	2009	2010	2011	2012
Market Value	$ 7,758	$ 9,160	$ 8,973	$ 9,021	$ 11,123	$ 11,024	$ 15,592
Cost	$ 3,697	$ 6,677	$ 6,702	$ 7,394	$ 8,012	$ 9,086	$ 10,906
Unrealized Gain	$ 4,061	$ 2,483	$ 2,271	$ 1,627	$ 3,111	$ 1,938	$ 4,686

After attempting to explain to the SEC that Berkshire believed Wells Fargo to be undervalued and that it had no intention of selling, it finally relented. In the first quarter of 2011 Berkshire recorded a $337 million "other-than-temporary impairment" charge, writing down the shares by approximately 9%. This happened despite having another block of 255.4 million shares with a gross unrealized *gain* of over $3.7 billion as of March 31, 2011. So, why the write-down?

The Accounting: The answer to the seemingly strange question of why an investment with an aggregate gain would be written down is simple. Berkshire accounts for gains and losses on a specific identification basis. The specific block of Wells Fargo shares the SEC was questioning was being treated on a stand-alone basis, just like it was that of another company. The fact that another block of shares had a large unrealized gain, and that the investment overall was in the positive, was inconsequential. Importantly, the adjustment was entirely GAAP earnings-based and had no impact on book value. All the accounting adjustment accomplished was to reduce unrealized losses already recorded on the balance sheet under 'Other Comprehensive Income' and into retained earnings. The net equity position was not affected, nor were there any tax consequences.

Side Note: As an interesting aside, among the four companies about which the SEC inquired, in addition to Wells Fargo, in September 2010 was an investment in Kraft Foods. Berkshire wrote down the value of three (Swiss Re, Sanofi Aventis, and U.S. Bancorp) as of year-end 2010, but resisted writing down Wells Fargo and Kraft. Ultimately it relented and wrote down the values of the latter two during the first quarter 2011.

IBM: The preceding also begs the question of whether Berkshire will be required to take a similar write down of its investment in IBM ($2 billion unrealized loss as of September 30, 2015), given the significant period of time shares have remained in a loss position. Time (or the SEC) will tell.

Conclusion: While I am reasonably well-versed in the language of business, there are many interesting nuances and technicalities that arise from time to time. Learning about them through actual examples, rather than though text books, has the added tendency of making the lessons stick that much better. I hope you have enjoyed learning a little more about accounting and about Berkshire. Any feedback (praise or criticism) is welcome, as are suggestions for other topics, accounting or otherwise.

Rationally yours,