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FIRST QUARTER:

Buffett gave a preview of Q1 results that will come out later this week. All information he shared will be posted on BRK website before Monday's market open. Much like many have suspected, 2003 could shape up to be a great year for BRK. Q1 pre-tax operating earnings were $1.7 billion before any gains from marketable securities (*coincidentally, securities gains made after tax net $1.7 billion also.*). Buffett made the comment that these are “the best operating earnings we've ever had”. Munger quipped “I hate to be the optimist but we've really added some delightful businesses”.

More importantly, the insurance businesses had a $290 million underwriting profit (would have been even better but results include $140 million of “pain-today” retrocessional losses). That's an annual run rate of over $1 billion underwriting profit! Float grew by $1.3 billion to stand at $42.5 billion at the end of Q1.

Five Years of No Cost Float!

Needless to say, Buffett thought insurance business “was in great shape” although “float probably won't grow much” for the rest of the year. Buffett predicted that over the next five years, BRK should be able to operate at zero, and possibly in some years, positive cost of float (for me this was the most imp. It sounds like in an environment of very low interest rates and excess cash on the balance sheet, Buffett is stressing his insurance divisions that underwriting profit is more important than growth in float*,(and the pay incentives are established to accomplish this)*

GEICO saw premiums grow by 16% in Q1 and April came in at +17%. GenRe made an underwriting profit and “was not a drag anymore”. Ajit Jain made a big underwriting profit and the other primary insurers are “doing remarkably well”.

Non-insurance businesses did not do great. They are feeling the effects of a soft economy (except for homes/autos). Buffett believes we are still in a soft recession and that economy will remain sluggish.

NEW ACQUISITIONS – MCLANE & CLAYTON HOMES:

Buffett shook hands with Wal-Mart to buy McLane's, a large wholesaler to convenience stores, Sam's Clubs and Quick Serve Restaurants. McLane's will do $22 billion in revenues this year but makes 1% pre-tax margins.

(Berkshire's total revenue last years was 42 billion, so this $1.5 billion acquisition will increase Berkshires Revenue by 52% in the 12 months after the acquisition is completed. In addition Fleming Co., one of McLane's competitors recently filed for bankruptcy and there is speculation that Flemings $8 billion in revenue might be ripe for picking).

It is a business with very narrow margins, you have to perform very well and Buffett believes McLane's does this. He welcomed their CEO (Grady Rozier) who grew business from $3 billion in 1990 when Wal-Mart took ownership. With Wal-Mart's ownership, certain potential customers wouldn't do business with McLane's because it would benefit their competitor (Wal-Mart).

Buffett was approached by Goldman Sachs, and Wal-Mart CFO came to Omaha last week. They shook hands on deal. "Deal makes sense for both sides. Wal-Mart knows we will be a good owner". Deal still needs to go through Hart-Scott-Rodino but expects this to be a non-issue and in a few weeks, McLane's will be a part of BRK.

Clayton Homes deal came about because 40 students from Univ. of Tennessee-Knoxville come to Omaha every year for a Q&A with Buffett. Students presented Buffett this year with a gift – book that is autobiography of Clayton Homes founder. Buffett followed the industry and called Kevin Clayton after reading the book. Buffett suggested price at which BRK would be interested in acquiring Clayton and deal came about.

Manufactured home industry got into trouble because "it went crazy on credit" 4-5 years ago. Conseco serviced $20 billion of mfg. home credit and also got into big trouble. BRK participated in bankruptcy of Oakwood.

All firms have lost ability to securitize loans. Last year 100,000 *(is this figure correct?)* new homes sold, 90,000 came back as repo's. Even for Clayton, who had been careful with loans, financing was getting difficult. With BRK as financial backer, Clayton should do well. "We will be useful to them. Buffett feels this is an interesting industry and manufactured homes will continue to have an important share of residential market.

EXECUTIVE JET

Net Jets will post a significant loss in Q1, due to write-down of planes. Made a modest operating profit in US, but had an operating loss in Europe. Used plane market, entire plane market is very soft. Too many planes has affected pricing of new planes. Despite loss, Buffett maintained it is a popular product and still growing as a business.

Three main competitors are all losing significantly on operating basis. Market share as measured from FAA in terms of value of planes is 75% for Net Jets and growing. Europe market is one-tenth the size of US and half miles flown in Europe are from US owners.

Buffett thinks there will be a shakeout. Noted Raytheon 10-K has "interesting info". Shakeout may be soon.

The long-term business model is still sound. Future market could have 10X the people flying today, however Buffett does not see an operating profit today.

FLOAT AS EQUITY – GROWTH OF FLOAT:

BRK float is $42.5 billion. Entire US P/C market has probably $500 billion in float so BRK has 8-9% of US P/C float and US is big part of world market. Buffett insisted that it will be difficult to grow float in the future and it is really important that it's at no cost. If $42.5 billion can be obtained and maintained at no cost, it is equity-like, except that it can't be counted in a liquidation.(*May Be counted in sale depending on Company*) But it has the utility of funds derived from equity. "If we get float at close to zero cost it has the utility of equity".

P/C business is not a great business, every now and then industry gets off track. It's a commodity and most P/C insurers don't get float at zero cost. "However it's a great business for us".

Munger added that with interest rates as low as they are now; float isn't worth as much to us short-term. But we have a long-term view.

Buffett added that BRK has $16 billion in cash on hand as of March 31st. currently getting 7/10 of 1% after-tax on that cash. "That doesn't make us salivate" But part of that money was used in $1.5 billion McLane's acquisition.

(*Charlie Added that float growth will slow because additional cash has only marginal value with short term interest rates so low)*

LIMITATIONS OF BLACK-SCHOLES MODEL IN OPTIONS PRICING:

Any option has value, but you have to understand that value. You don't need B-S to understand that value. "People who are slick, get options for very low dollar amounts" B-S attempts to value options mechanistically. Biggest variable is past volatility. But this is not always the best indicator. BRK has low beta but that doesn't mean that the value of a BRK option is less than another stock with high beta. It's a mechanical system that gets mispriced from time-to-time.

Last year, we revealed that we made $120 million on a bet at the expense of "other side" that used mechanistic system. (S&P option?).

Munger added that Black-Scholes is a "know-nothing" system. If price is teaching you, then B-S is OK. However, the minute you get into a longer-term type option – its not so useful. Costco, in a relatively short period issued options with strike prices of $30 and $60, B-S valued the $60 option higher than the $30 option – "its insane".

Buffett added that he would like it if you could give him prices on 3-year options for a few hundred companies priced by B-S and let him choose among them. He noted that was part of the thinking in SQUARZ where he gave up option value but got more value back.

ALIGNING EMPLOYEE COMPENSATION TO SHAREHOLDER INTEREST:

Munger said that stock option system will give great reward to some (*Not responsible for price gain)* and nothing to others giving great effort. Rewards are capricious.

Buffett added that BRK inherits options from acquisitions. GenRe employees benefited from other BRK subsidiaries operating performance at a time when GenRe didn't deliver much over a number of years. He believes in tying performance to compensation.

Buffett has seen more misdirected compensation in last ten years than previous 100. During 1990's there was wealth created, but also large wealth transfers. Compensation systems need to include opportunity cost of capital and tie rewards to operating performance sphere of control.

Munger added "if we are right, the implication is that 99% of corporate compensation systems are crazy. We're not against rewards for people who make big contributions"

Buffett chimed in – executive compensation is not a market-based system like a baseball player salaries. Player negotiates with owner who lays out his own money. There is a "parity of concern". Labor negotiations are like this too. You sit across the table and try to negotiate with union and there is a fight over each transaction in the contract. For compensation committees, "it's like play money" Its other people's money. Most executive compensation is not a real negotiation.

EXPECTATION OF INFLATION AND OUTLOOK FOR STOCKS

No question that low inflation is a big plus for investors. Low inflation of 2% + GDP real growth of 3% = 5% nominal GDP growth. Over the long-term, corporate profits will also grow 5%. Add dividends of 2% and you can expect 7% total returns. Starting point in terms of market price level (overvalued/undervalued) will affect that somewhat but basically expect 7%. Problem is when people are expecting 14-15% as happened in late 1990's. Math isn't bad, just bad relative to what investors were expecting.

7% isn't the end of the world. You have $10 trillion economy that may someday turn into $20 trillion. You have 100 million people in US workforce using your capital to create 10 trillion of goods and services.

High inflation can turn real results into zero or even negative returns.

STATE OF ECONOMY – OUTLOOK FOR CONSUMER/RISING INCOME INEQUALITY

Consumer are better off today but not dramatically better. Buffett doesn't have broad ideas about this, but thinks American economy will do OK.

Charlie remembers when it used to cost $18 to make station-to-station call to San Francisco – this represented an average week's wages.

Consumer businesses are soft. Furniture business was soft in Q1. Buffett thinks we have been in recession for two years. GDP is up 2% over that time, but population is up too, so GDP/capital maybe only 1% growth. It's GDP/capita that counts. GDP lately also included extra police, extra security at airports – it's not what we want, but what we need and it goes into GDP. Cost of war goes into GDP. If we lose planes and have to build new ones to replace lost fighters – that goes into GDP. In Buffett's opinion quality of GDP growth lately isn't something that's talked about.

Munger added that figures about income inequality obscure the fact that people move through income bands. If the Duponts' have to clip coupons and come down the economic ladder, and someone invents Pampered Chef and moves up, it creates churn. Churn is what makes people think the overall system is fair.

ACCOUNTING BOOK REFERENCE

Buffett admitted he didn't really have one. Mentioned some text he read in college. It's a framework that you build upon by reading annual reports and business magazine articles that contribute to knowledge. It's a lifelong process. "If I can't understand 10-K, then maybe management doesn't want me to understand."

Munger added "Asking WEB about good books on accounting is like asking him for good books on breathing."

INSURERS RISK EXPOSURE IN CREDIT DERIVATIVES

Credit guarantees has become very popular with standard p/c insurers, many of whom really don't know what they're doing. It's easy, get money in exchange for a piece of paper and a promise.

In mid-1980's, Mutual of Omaha went into reinsurance market. They didn't write many contracts but succeeded in losing half their equity which had built up over decades. "If you're willing to write under priced policies, people will find you. Even if you're in the middle of the Atlantic, brokers will swim to you ….with fins showing."

Cash comes in and it seems easy. GEICO gained $70 thousand in premiums from some policies written some time ago. The claims on those policies have been $93 million … so far.

Buffett continued “back-tested arrangements based on studies of risk class based on credit rating are OK but the problem is correlation. Risks can accumulate. Example, the telecom industry was an unrecognized concentration of risk.

VALUE OF AAA RATING TO INSURERS –
IMPACT ON SWISS RE, MUNICH RE

AAA rating means BRK gets offered first,….and last. But Swiss Re and Munich Re losing AAA doesn't mean BRK is accepting lower risks or writing with less discipline. Gen Re has been tightening.

Munger “I hope we're better underwriters than Munich Re…”
Buffett cuts Charlie off – “Munich Re is a fine company. Remember Charlie, we praise by name, and we criticize by category.”

BRK BUYING REMAINDER OF COLOGNE RE

Press misreported facts on this deal. GenRe acquired Cologne Re with a put/call feature on the remainder. We (BRK) bought with intention to buy all of Cologne Re – it was a fait accompli that we would exercise option when it came time. Put/call feature became effective this year and something had to be done and we always knew we would own all of it. Press implied that something was new but it wasn't.

LONG-TERM VISION FOR MEC

Buffett feels PUHCA is outdated but can't predict that it will be repealed. Feels BRK brings something to the energy field. With or without PUHCA repeal, MEC is already significant and will become bigger. Its certain that BRK will look at big deals, however whether they get one made is uncertain. “These energy businesses aren't lemon-aid stands” so acquisitions if they happen will be big.

MEC management has contributed to BRK by helping with other deals that MEC couldn't do, but BRK could and they didn't get any compensation for it.

Munger feels that energy is an enormous field and that “modern civilization needs energy”.

FORTUNE ARTICLE – DERIVATIVES WARNING

Carol Loomis edits annual Chairman's letter. Buffett thought derivatives section would benefit wider audience than reads BRK report. Section doesn't talk about BRK results so no reg FD issue in pre-releasing.

Buffett predicted again that there is a low, but not insignificant risk that in 3,5, 20 years derivatives could accentuate in a significant way systemic problems. He hoped article would be a mild wake-up call. Saw it recently in the energy field and it destroyed or nearly destroyed some companies.

In 1998, credit markets nearly paralyzed because of small hedge firm LTCM. Buffett and Munger are thinking about low probability events all the time. Munger added that in engineering, people put in safety systems and safety margins – especially in atomic power plants for example. In finance, people "don't give a damn… and the accounting doesn't help." Munger said he is more negative on this than Warren. In 5-10 years "I'd be surprised if we don't have a major blow-up".

Buffett added Coca-Cola can deal with forex change, but when KO lays off currency risk and other firms do too and it concentrates in a few hands. And those firms are vulnerable due to weakness of those institutions due to high leverage and intersection between those institutions who all have the same culture – there's a risk of a systemic weakness.

FANNIE MAE/FREDDIE MAC – DERIVATIVES EXPOSURE

Buffett explained that an operation has a problem in matching assets and liabilities duration and timing inherent in a mortgage instrument due to optionality. Fannie Mae can have a 30-year instrument if it's a bad deal (for Fannie Mae) and a 30-minute instrument if it's a good deal (consumer refinances). And the consumer has gotten savvier and penalties aren't that high so consumer isn't shy about getting a better deal if it's in consumers' interest.

If you run a huge institution, that is highly leveraged, you'll try as hard as you can to match assets and liabilities – but it's not easy to do. Fannie tries to do that in a number of ways, including using derivatives and they're very, very good at it.

However, it can't ever be perfect. The thing that destroys institutions are the five-sigma and six-sigma events. Financial markets don't lend themselves well to modeling these in the real world. Gaps or discontinuities can cause a highly leveraged institution to come down.

I'd be terribly concerned about optionality built into assets. I'd try to reduce those gaps in a conservative way. I'd also worry about counterparties. The terrible thing that is happening to you is probably also happening to your counterparties.

Munger added – Fannie Mae and Freddie Mac weight risk counterparties won't pay lower than we do. And counterparties are behaving in a way that is much less conservative than Fannie and Freddie.

GEN RE – GOODWILL STATUS/POSSIBLE IMPAIRMENT

If 1998-2001 was representative of the future, then you'd be looking at an impairment charge. GenRe is worth more today than when we bought it. Buffett gave example that will be in 10-Q of changing discount rates on workers comp from 4.5% to 1% to be more conservative. He was emphatic that GenRe will create zero cost float.

DISCOUNT RATE TO USE AT A TIME OF LOW INTEREST RATES/HOW TO THINK ABOUT OPPORTUNITY COSTS

Buffett uses the same discount rate across all securities he is looking at. Doesn't use current short-term rates. In fact, he maintains same minimum threshold whether rates are at 6-7%, 3-4% or 1%. Doesn't get hooked on making long-term investments locking in short-term rates.

Buffett's expectation from investments is 10%. He wants equities which will return 10% or more and thus set threshold at 10% which is not that high after-tax. WEB is guessing that he will get opportunities to invest at 10%. If interest rates were to settle in a prolonged period of very low rates - he might adjust this hurdle downward a bit.

HOW BRK MANAGERS FEEL ABOUT COMING TO ANNUAL MEETING

Managers not required tocome. They come because they want to and volunteer to come as do many of their employees. They pick up new tricks from each other but none of it is mandated or managed from Omaha. Managers will work with each other and look at what they pay for certain items or services and may decide to work together but its not sponsored by BRK HQ.

RISING COST OF HEALTH CARE AND EMPLOYEE BENEFITS

Fastest rising cost is workers comp., unrelated to health care. Costs rising. This is an inflationary part of the economy. It's a raw material cost and it’s going up, but we don't have any answers. Certain states are better than others

Munger added that quality of health care is going up enormously and country is richer so its “not crazy if US wants to spend 15% of GDP on health care” Buffett noted that other countries spend less % of GDP so perhaps might be getting better value for their dollars but not sure about this.

HOW DOES BUFFETT DEFINE SUCCESS & HAPPINESS

Buffett “you'll be successful if the people you want to love you, really love you. If Charlie and I could just buy $1 million of love, then we wouldn't have to try to be lovable” Buffett said he and Charlie know of many very successful people who deep down are not loved – even by their families.

Munger gave example of funeral of Hollywood movie producer “the funeral was so large, everyone wanted to make sure he was dead.”

INFLUENCE OF MUNGER ON BUFFETT'S INVESTING APPROACH

Buffett credited Munger and said See's Candy deal did teach both of them about wonderful businesses. If See's had asked for $100 thousand more, they were prepared to walk. Munger's friend Ira Marshall told them – you guys are crazy, you're underestimating quality of the business. They took criticism and listened.

Munger added that you could say BRK was built on listening to criticism. They learned a lot from Graham who focused on quantitative, but he didn't dismiss qualitative, but felt he could make a lot of money just focusing on quantitative.

Buffett said Munger should take a lot of credit. Over time Buffett moved from cigar butts to paying up for quality.

DO COMPANIES THAT LOSE COMPETITIVE ADVANTAGE, REGAIN IT?

Buffett said he did not know of any. Some companies get into trouble but not from losing competitive advantage. GEICO got in trouble in 1970's, but not because it lost its core advantage but rather took on some bad business for growth.

Pepsi had marketing advantage pre-WWII due to selling twice as much cola for 5-cents. World War II came and costs went way up (sugar) and Pepsi had to alter marketing formula and was able to recover.

Gillette maybe lost a bit of its advantage in 1970's due to rise of disposables. Packard had upscale image in its automobiles then went downscale to capture increased sales, sales did spike but it lost its upscale image and never recovered. Some department stores have made the same mistake (going downscale).

BUFFETT"S RECENT COMMENT ABOUT BRK PRICE

Buffett recalled that in Fortune article he said that it was more attractive than owning general market. He never thought stocks were cheap at any time over the last five years. He wouldn't swap BRK for S&P 500 (tax-free) if given the chance. He's never recommended either outright purchase or sale on BRK.

Munger added that a fretful attitude to owning stocks is the enemy of the long-term investor. Focus on company's results not price.

Buffett did recall that on March 12, 2000 – day Nasdaq hit high and BRK hit recent low – he did say in annual report released that weekend that he would repurchase at $45,000. But preference is to buy businesses and add to BRK business. If he thought that BRK was significantly undervalued and probability of allocating cash at better returns for the foreseeable future was low, he might repurchase shares but its not his #1 preference.

KEY QUALITIES IN MANAGERS

WEB/CM love managers who have passion for their business. “We ask if they love the business or love the money?” They get calls from bankers who represent firms who bought and are trying to resell a business but “it's a piece of meat to them, how do I know that they haven't doctored the numbers?”

BRK managers are motivated the same way WEB/CM are motivated. Munger added that what matters is competence and passion – BRK has a peculiar competence/passion. Passion probably matters more because competence gets tested by competition along the way well before possible acquisition opportunity arises for BRK.

WHERE BUFFETT GETS INVESTMENT IDEAS

Buffett reads a lot and knowledge accumulates – reads a lot of 10-Ks, annual reports. Back in his twenties, he visited companies but today relies on almost exclusively publicly available info. **He says he does not find it particularly useful to talk to management** – they aren't necessarily the best info source. When they buy business, they'll check out management but “don't give a hoot about management projections”.

WEB/CM said they read business journals, newspapers (CM said Wall Street Journal is indispensable) but that they never read analysts reports. Buffett said “they'll read'em if funny papers aren't available.”

You only need one good idea every year or so. You don't need to be right on 20% of stocks or 10% of stocks or even 5%. Munger noted that 90% of investment management doesn't think like WEB/CM do.

CURRENT MARKET, OUTLOOK FOR INTEREST RATES

BRK has $16 billion in cash because we don't see anything that would cause us to part with that cash. Last year, BRK bought a lot of junk bonds but Buffett said he is not finding value there anymore. “You had a somewhat disorganized junk bond market last year”

Munger noted that in terms of future opportunities, its unlikely that he or Buffett will see a 1973/74 or 1982 again so “we'll have to grind it out”. In Japan, 10-year bonds yield five-eighth's of a percent. If that could happen in Japan, it's not out of the question that it could happen in the US.

INTRINSIC VALUE CALCULATION – HOW DOES WEB KNOW IV WON'T DECLINE

Model builds in what you think will happen to value and cash flows over time – so its built into your calculation of IV. With pipelines, surprises over time should be few but if contracts expire in two years and you expect more competition – its not that IV is going down but rather you're building that knowledge into your IV calcs. If properly calculated, you build in expected declines in earnings. Lots of businesses earnings are going to go down, but you'll never see it in an investment prospectus. Trying to project earnings always upward is nuts. "The idea that you're setting out to do something you know you can't is insane."

For example, Buffett made a mistake in Dexter Shoe. We thought that current levels of operating earnings would stay at those levels. If you feel you can't come up with reasonable estimates, then you should move on.

IMPACT ON US DOLLAR DECLINE AND HIGH INFLATION ON BRK

Munger answered that all kinds of things can happen that are unlike anything in recent history. In the long-term all currencies "go to hell" "Will some politicians ruin the currency? – the answer is yes."

Buffett said inflation is always latent – right now its in remission. It's a function of how legislators govern. Probability of high inflation in twenty years is not zero.

Most BRK liabilities are in US dollars and very little in foreign currencies but they are matched by assets in those foreign currencies. BRK has $2 billion in foreign currency-denominated assets – mostly Euros.

HOW DOES BRK GENERATE DEAL FLOW

Buffett doesn't like the term - connotation of something to be bought and sold. The key to getting opportunities is assuring that BRK is in position to get calls that we should get. That wasn't true twenty years ago. It builds on itself. If first acquiree is happy, then the second – it builds on the probability that similarly-minded businesses call us. Snowball has built up and Buffett hopes it gets bigger

Jack Ringwalt.

Buffett talked in funny terms about 1967 acquisition of National Idemnity for $7 million. It was known (*locally in Omaha)* that something would set off Jack Ringwalt, and every year for "about 15 minutes" he wanted to sell. Munger kidded that everyone referred to it as "Jack is in heat". One day, Munger friend called and said "Jack's ready". (Laughter in auditorium). Meeting was in Charlie's LA office and Jack was 10 minutes late because he was looking for parking meter that still had free time left. Buffett said “I knew right then that Jack was my kind of guy”. Deal got done but Buffett could feel Ringwalt was remorseful and was looking for excuse to kill deal. Jack said “I suppose you want audited financial statements?” Buffett knew that if he asked for them, Jack would kill deal so he said “nope”. This went on for a while but eventually deal was closed and ultimately Ringwalt realized he still ran the business.

WHY DOESN'T BRK BUY GLOBAL CROSSING FROM BANKRUPTCY

Kind of a dumb question but Buffett said he didn't have the faintest idea how to value these types of businesses and he said “I might add that those people who thought they could value it three years ago didn't either.” Whether its BellSouth, Verizon – it's a game Buffett doesn't understand. “I don't worry about what I don't know. I worry about being right about what I do know.”

He said that BRK might buy junk bonds in this area but he expects losses in junk bonds. Overall, he expects to make a profit on a basket of junk bonds. But you're dealing with companies that don't have a margin of safety and sometimes managements that aren't entirely honest or capable. “We want to buy businesses that have virtually 100% certainty to be great.”

WHAT PROMPTED BUFFETT TO BUY $100 MILLION OF LVLT CONV. PREFERRED

We like the people, they owed too much money and they recognized it. They're doing some intelligent things – WEB doesn't have a strong opinion on the business so its about the management. *(“a mild endorsement”)*

IS COCA-COLA STILL AN INEVITABLE

KO is still gaining global share and it has a huge distribution system. This is helping them to get into the minds of more and more worldwide consumers. Over time they should be able to make a little more profit per drink.

COMMENT ON ENTHUSIASM FOR MANUFACTURED HOUSING & CLAYTON HOMES INVESTMENT

While practically everyone is losing money, Clayton is making money. Clayton has system where profit and loss goes to dealer. If he signs up bad credits, dealer will get loss and will even get repo back. Creates a different incentive than industry where dealers will sign up “warm bodies”. *(Dealer had nothing to lose if buyer turns out to be poor credit risk. Also Dealers were Jacking up prices and adding many points to mortgage Buyer attempting to sell could find himself underwater buy 25% to 30%. So many just walked away from house)*

Not an easy business. The book (autobiography of Clayton founder Buffett received as gift) describes some of the gamesmanship. These industry practices are coming back to roost.

Clayton is the only one in the industry who still can securitize their loans and only in a limited way. They'll do better with BRK. **We won't securitize Clayton's loans, "we'll keep them"**. Munger added when you see a company with gains in securitization – its fishy.

COMMENT OF VALUE CAPITAL

Buffett said that BRK has made a lot of money over time with the Byrnes' (father and son). Son is running a hedge fund specializing in fixed income. BRK has 95% of capital, Byrne has 5%. Operates with less leverage than similar firms. This is all disclosed in upcoming Q1. Involves derivatives and some borrowed money. Buffett has looked at all positions and is comfortable with them. Accounting rules force BRK to consolidate results and this creates a little distortion so BRK will break out in 10-Q.

EBITDA AND OTHER PITFALLS IN ACCOUNTING

WEB felt that BRK handed goodwill amortization the correct way and highlighted it in past annual reports and now current accounting rules have caught up in not having to amortize goodwill. "We're willing to tell you when GAAP doesn't fairly represent economic reality".

Not thinking about depreciation as a real expense is crazy. At some point assets need replacement or they become obsolete. There are very few businesses where you can spend less than depreciation and maintain competitive position. BRK will spend more than depreciation this year, same as last year and same as year before that. Its "reverse float" in that you have to lay out cash up front.

"Bullshit Accounting"

Munger said that you would be well-served if as you listened to presentations; you substitute for references to EBITDA with "bullshit accounting". He also thought pension accounting horribly understates liabilities. WEB added that he sees companies reporting "income" of $100s of millions while being under funded in their pension by $ billions.

They also took another shot at options by dismissing that expense is reflected in footnotes. Buffett mused "why not put all expenses in footnotes and have profits equal revenues. Munger chimed "it's a rotten way to run a civilization. Rotten accounting is like rotten engineering." Current accounting is somewhere between "crazy and crooked". Buffett was clearly amused that four audit firms (called them the "final four" to laughter) are finally saying that options are an expense.

BOND INVESTMENT STRATEGIES/BANKS AS AN INVESTMENT/COST OF CAPITAL

Not a long life to Buffett's bond strategies – he clearly wouldn't talk about what he was doing other than to say that formula he's using is opportunistic and he is set to engage in it when the opportunity arises.

Banks are a good business most of the time – particularly if management doesn't pursue latest fads. WEB/CM were surprised that margins haven't been competed away. They feel that they mis-appraised the industry and they didn't think it would be as good as it has been. In a world of low rates of interest, it's surprising that banks still make high returns on capital. Some of that is the inherent leverage but some banks continue to make high returns on assets.

Cost of capital is determined by looking for the most intelligent thing they can do with capital BRK has. They measure alternatives between relative investments, dividends and repurchases. Munger said that Mankiw at Harvard has a book that explains it well based on opportunity costs. The rest of the world uses formulas, including cost of equity – "it's a mental malfunction"

CHINA INVESTMENT

WEB noted that BRK has five investments in companies domiciled outside USA. In Hong Kong – 5% of public stake must be reported even though Chinese government owns 90% of shares. So BRK had to report 13% of H- shares (owned by public) vs. total enterprise value. WEB/CM don't make any judgments about China – they prefer US because they understand the laws, etc. But they feel they understand the oil business even in China. The stake is not a big deal and was disclosed due to peculiarity of HK securities law.

PHILANTHROPY

On philanthropy, CM says there are different approaches – give as you go along or Buffett system of moderate giving followed by immense giving. Buffett used ovarian lottery story and talked about he and Charlie having 50-1 odds of being born in the USA. They both feel that their money has to go back to society.

RETURN ON CAPITAL

Ideal business is one that earns large amounts on capital and has opportunities to redeploy large amounts of capital. Unfortunately, these situations are rare. Most businesses, like KO or See's Candy don't require incremental capital. They generate lots of money but they don't need any more additional cash. See's generated over thirty years almost $1 billion in cash and if WEB had reinvested in See's business it would have earned lousy returns.

Fortunately, BRK structure facilitates redeployment of strong cash generation. Munger noted that there are two types of businesses. Business that earns 12% but creates no excess cash because every dollar has to be reinvested just to stay in place (used example of farm biz where his friend would show his profits by pointing to the farm equipment in the yard). Second type of business generates cash at year-end that sits on balance sheet which can be redeployed and taken out of the business without biz missing a beat.

ALLOWING /ACTIVIST ASKING FOR BUFFETT'S HELP

Another dumb question based on crowd mood. Buffett says he doesn't do requests. He gets them all the time and they ask him to get to someone. He worries that if they say yes are they saying yes to cause or because WEB is the one asking. He doesn't want to put friends and acquaintances in that position.

On public policy, WEB will occasionally write an op-ed (in fact he has some written that he's waiting on right time to send if at all). But overall, thinks there is a danger to “I'm rich therefore, you have to listen to me.” He hates it and thinks others do too. Worries about overexposure and thinks its always a risk.

On social security, it's a good intergenerational compact. Basically, according to Buffett, it says that if you produce for society, society will provide some basic level of income security. He thinks it's a good system and country is better off because of it.

BRK COMPENSATION POLICIES, SUCCESSION IF SUBSIDIARIES CEOs NEVER RETIRE

WEB/CM set compensation differently depending on business. If business doesn't need much capital – incentive will be based on profits earned. If there are substantial amounts of capital employed – then they build it in. They set the compensation system for the operating subs' CEO and then let subsidiaries design reward system for employees themselves without any directives from Omaha.

As far as they can tell, morale is unaffected by CEO tenure. As everyone knows BRK has no retirement policy. If there are people within ranks who want to be #1 they probably go somewhere else. Buffett feels that they face a management succession decision every 18 months or so.

ECONOMIC VALUE ADDED

They wouldn't dream of using EVA. The basic concept of setting hurdle rates based on opportunity cost is right. But they don't need to use the formulas – it intuitive.

OPINION ON TORT REFORM

Buffett is sympathetic but thinks he and Charlie have very little clout compared to power of trial lawyers. Current system imposes tremendous frictional costs. He used example of Directors and Officers liability insurance. Everyone knows that companies will pay and it becomes a kind of game. It is similar to executive compensation. There is a "lack of parity". Charlie mused that D&O liability insurance should be abolished, it would be hard to find directors but after system adjusted, maybe we would get better corporate governance.

However, due to some activity in corporate America, they are glad that there are trial lawyers. There is usually some underlying wrongdoing, although eventually system maybe goes a bit too far. "Half the time they are suing someone that did something terrible but then socialize the cost."

Munger talked about workers comp in California having terrible abuses - "institutionalized fraud". Talked about a friend who took a plant from Texas to Utah and workers comp went from 30% to 2%. Present system "is crazy"

FRUSTRATION ABOUT BUYING CO'S IN BANKRUPTCY

Buffett talked about Burlington Industries experience. BRK had made $500 million bid but bid had to remain outstanding for several months. Negotiated break-up fee of $14 million but judge tried to reduce it because he felt it was too much to charge. BRK backed out and there will be a new process and there will be another buyer.

WEB explained that in his opinion its too much of a risk to BRK to commit to a fixed price bid of $500 million for several months without adequate protection. Felt that BRK was giving up option value. Many things can go wrong in the interim (again WEB/CM are thinking six-sigma) Buffett felt that $14 million was not enough of a put option to protect BRK when compared to the premiums on similar put options available in the market place. Feels that he needs much higher break-up fee to compensate for option value he is giving up in order to make fixed price bid that has to stay outstanding for months. Came away thinking that it may be too hard for BRK to buy companies out of a Chapter 11 process.