



# TRUST AND CONSEQUENCES

## A SURVEY OF BERKSHIRE HATHAWAY OPERATING MANAGERS

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*“The choice to operate in a decentralized manner from the beginning reflected a belief in the value of autonomy and a conviction that people properly entrusted with authority will generally exercise it faithfully.”<sup>1</sup>*

– Lawrence Cunningham, *Berkshire Beyond Buffett*

### INTRODUCTION

For much of its history, Berkshire Hathaway has been regarded primarily as an investment vehicle rather than a bona fide corporation. One reason for this perception is Warren Buffett’s success as an investor and the outsized contribution of investment returns to the company’s growth in its early years under his leadership. However, as Berkshire Hathaway has expanded beyond its core insurance operations—with investments in railroads, energy and regulated utilities, specialty finance, manufacturing, service, and retail companies—more attention is being paid to the structure by which these entities are managed (see Exhibit 1).

Two notable features of the Berkshire Hathaway system are its high degree of decentralization and the considerable autonomy afforded to the managers of its operating subsidiaries.<sup>2</sup> According to the company’s annual report, “There are essentially no centralized or integrated business functions (such as sales, marketing, purchasing, legal or human resources) and there is minimal involvement by our corporate headquarters in the day-to-day business activities of the operating businesses.”<sup>3</sup> Vice Chairman Charlie Munger describes the company’s system as “delegation just short of abdication.”<sup>4</sup>

Other notable features of the Berkshire Hathaway system are its long-term investment horizon, its pledge not to sell subsidiaries, and its emphasis on ethical behavior. As Buffett explains, “We give each [manager] a simple mission: Just run your business as if: 1) you own 100 percent of it; 2) it is the only asset in the world that you and your family have or will ever have; and 3) you can’t sell or merge it for at least a century.”<sup>5</sup> Separately, Buffett has said, “We can afford to lose money. But we can’t afford to lose reputation, not a shred of reputation. ... I tell [our managers] if anything is close to the line it’s out.”<sup>6</sup> According to Munger, “We try and buy

companies so permeated with a good ethos that they don’t need a lot of direction and checking and so forth from headquarters. ... What we’re trying to live in is a seamless web of deserved trust.”<sup>7</sup>

### SURVEY OF BERKSHIRE MANAGERS

To better understand the Berkshire Hathaway management system, we surveyed the chief executive officers of approximately 80 Berkshire Hathaway operating subsidiaries. Responses were received from CEOs representing a mix of insurance and noninsurance subsidiaries of various size. Respondents have an average tenure of 12 years as CEO (broadly in-line with the average tenure across all subsidiaries) and include a mix of executives that were and were not CEO when Berkshire originally acquired their companies.<sup>8</sup> Responses were remarkably consistent across the sample.

The CEOs of smaller subsidiaries (less than \$1 billion in revenue) report that one to two months passed between initial discussions with Berkshire Hathaway about a possible acquisition and agreement to acquisition terms. The CEOs of larger subsidiaries report that discussions lasted longer: six to nine months. On average, smaller acquisitions also took less time to close following a signed agreement (one to two months) than larger acquisitions (four to five months).

Respondents report few governance changes following an acquisition by Berkshire Hathaway. The most frequently cited changes are the elimination or change in composition of the board of directors and changes to the terms of CEO compensation contracts. Some insurance subsidiary CEOs report that changes were made to the company’s internal audit and risk management practices. Subsidiaries that were formerly publicly traded companies report that they eliminated their investor relations departments. Still, changes appear to be modest. According to one respondent, “The only change is that I now discuss any major capital acquisitions with Warren. We run the business the way we always have.” The data is largely consistent with public statements made by Warren Buffett about Berkshire Hathaway’s acquisition practices.

Subsidiary CEOs provide monthly financial statements to Berkshire Hathaway headquarters. A few provide this information quarterly. For the most part, Berkshire Hathaway CEOs have infrequent contact with Buffett. Most report having phone conversations with him on a monthly or quarterly basis. None of the respondents talk to him on a pre-established schedule, and all report that they initiate the communications themselves.

In terms of oversight, there is strong agreement that Berkshire Hathaway affords its operating CEOs a high level of independence in managing their businesses. There is also strong agreement among managers that they would have less independence if their business were owned by a company other than Berkshire. In the words of one respondent, “No one else gives a company this kind of freedom.”

Subsidiary CEOs also agree that their financial performance is better than it would be if their company were owned by a company other than Berkshire Hathaway and—interesting enough—also better than if it were a standalone company. This supports a common conjecture that ownership by Berkshire Hathaway provides financial benefits to subsidiaries. According to one respondent, the company’s operating performance has improved under Berkshire’s ownership because it affords management greater freedom to operate independently and encourages a long-term focus. Another respondent cites Berkshire Hathaway’s brand value, which it references in its marketing. The CEO of an insurance subsidiary cites the parent company’s financial strength as removing surplus limitations on growth.

Berkshire Hathaway operating managers also believe that ownership by Berkshire allows them to manage their businesses with a longer performance horizon than would be the case under different ownership. Respondents vary widely in terms of what performance horizon they use to manage their companies, with estimates ranging from 3 years to 50 years (median 5 years, average 12 years). This compares with an estimated 1- to 3-year performance horizon if their business were owned by another company (median 1 year, average 2 years).<sup>9</sup>

Most Berkshire Hathaway CEOs believe their compensation would be higher if their business were owned by a company other than Berkshire. All claim that their annual bonus is calculated using only two performance measures. (A typical large corporation uses 2.4 performance measures, on average.<sup>10</sup>) The most frequently cited measures are earnings, return on equity, and operating or profit margin. One reports sales growth as a goal. The stock price performance of Berkshire is not a performance measure for even very large subsidiaries.

All respondents have identified at least one successor as CEO

and acknowledge that they are responsible for the selection of this individual. They convey their views on succession in a letter to Warren Buffett which includes their primary recommendation for a successor, other potential successors, and the strengths and weaknesses of candidates. (By comparison, only half [51 percent] of public and private companies claim to have identified a permanent successor to the current CEO.<sup>11</sup>)

There is strong agreement among respondents that a common culture is shared across Berkshire Hathaway subsidiaries. The most frequently cited attributes of this culture are honesty, integrity, long-term orientation, and an emphasis on taking care of the customer. Respondents also agree that the culture of Berkshire is directly influenced by the “tone from the top.” According to one respondent, the main messages conveyed by Berkshire Hathaway headquarters are:

1. *Never lose reputation for the Berkshire Hathaway brand or the company’s brand;*
2. *Run your business as if it is the only family asset for the next 50 years; and*
3. *Integrity comes first.*

To this end, operating managers report being “very clear” about which actions or activities within their business would be condoned by Berkshire Hathaway headquarters and which would not.

For the most part, there is broad agreement, but not complete consensus, on when Berkshire Hathaway headquarters would get directly involved in their business were something unexpectedly negative to occur. Operating managers tend to agree that Berkshire Hathaway headquarters would not get involved following the unanticipated departure of one or more of the CEO’s direct reports; labor disruption; supply chain interruption; complaint by a large customer; environmental, legal, or regulatory action against the company; an event that impacts the product or service reputation of the company; or a modest decline in sales. Respondents expect Berkshire Hathaway headquarters to become “somewhat involved” were the company to experience a major decline in sales; a modest restatement of previous financial results; or an event that impacts the subsidiary’s business reputation. Still, this reaction is not universally anticipated. A minority of respondents believes that Berkshire Hathaway headquarters would not get involved even in these circumstances. Respondents agree that Berkshire Hathaway headquarters would become “very” or “somewhat involved” only under two scenarios: first, if an event impacts the parent company’s reputation; second, if the company

were to issue a severe restatement of previously reported financial results.

Berkshire Hathaway subsidiary CEOs report communicating infrequently with their counterparts at other subsidiaries. Subsidiary CEOs interact with their counterparts on a semiannual or quarterly basis. These communications are voluntary and not required by Berkshire Hathaway headquarters.

Finally, the managers of Berkshire Hathaway subsidiaries widely believe that Berkshire Hathaway will experience few, if any, changes following the eventual succession of Warren Buffett. Almost all respondents believe the company's culture will not change. Most also believe the company will not operate with more internal controls, that the subsidiaries will experience no change in independence, and that the company will not insert additional layers of management between them and Buffett's eventual successor. Only a few believe that the structure of their compensation contracts will change. In the words of one respondent, "The more I interact with the board at Berkshire and other Berkshire managers, the more confident I am in the future of Berkshire post Warren."

#### WHY THIS MATTERS

1. The Berkshire Hathaway operating system is built on the notion that managers will perform at a higher level if they are granted autonomy and allowed to run their businesses from a long-term perspective without intervention from headquarters. Survey data suggests that the company has been successful in creating such an environment. How important is this "trust based" system to the company's results?
2. Survey data suggests that Berkshire Hathaway headquarters takes a very hands-off approach to a wide range of business disruptions, including executive turnover, customer and supplier issues, sales decreases, and unexpected legal, regulatory, or environmental claims. When is it appropriate for corporate overseers to defer to the judgment of management in solving operational problems, and when is greater involvement warranted? Does Berkshire Hathaway "draw the line" in the right place?
3. Berkshire Hathaway claims to have "essentially no centralized or integrated business functions" and "minimal involvement" in business activities. Should such a system be adopted by companies more broadly? Would it lead to better or worse outcomes, on average? In which settings might it succeed, and in which settings might it lead to more failure?
4. Berkshire Hathaway managers are uniform in their belief that their companies benefit from a long-term investment horizon. At the same time, prominent commentators continuously bemoan the short-term orientation of many publicly traded corporations, in part due to pressure from investors and activists. Is it true that public companies are short-term oriented? Why is Berkshire an exception to this trend? What actions can corporations take to extend the investment horizons of management?
5. Berkshire Hathaway managers are also uniform in their belief that integrity is a critical operating principle for the company. How important is integrity to business results? To what extent is ethical behavior influenced by "tone at the top?" To what extent is it influenced by monetary incentives, recruitment practices, and other organizational features? ■

<sup>1</sup> Lawrence Cunningham, *Berkshire Beyond Buffett: The Enduring Value of Values*, (New York, NY: Columbia University Press, 2014), p. 105.

<sup>2</sup> For a detailed review of the Berkshire Hathaway management system and culture, see Cunningham, op. cit. See also David F. Larcker and Brian Tayan, "The Management of Berkshire Hathaway," Stanford GSB Case No. CG-16 (January 1, 2009); and David F. Larcker and Brian Tayan, "Corporate Governance According to Charles T. Munger," Stanford Closer Look Series (March 3, 2014).

<sup>3</sup> Berkshire Hathaway, 2015 Annual Report.

<sup>4</sup> The DuBridge Distinguished Lecture Series, "A Conversation with Charlie Munger," California Institute of Technology, Mar. 11, 2008.

<sup>5</sup> Berkshire Hathaway, 1998 Annual Report.

<sup>6</sup> Transcript: "A Conversation with Warren Buffett," The Charlie Rose Show, July 10, 2006.

<sup>7</sup> Wesco Financial, 2008 Annual Meeting, cited in: *Outstanding Investor Digest*, (August 31, 2008).

<sup>8</sup> Survey data collected between June and September 2015. Questionnaires were mailed to the chief executive officers and executive chairmen for each of the main operating subsidiaries listed in the company's 2015 annual report. Responses were submitted anonymously. Although some executives identified the subsidiaries they manage, they were not required to do so. All respondents provided descriptive statistics of company size and the nature of their operations. Because responses were received from only a minority of companies, we consider these results to be descriptive rather than scientific.

<sup>9</sup> These estimates are consistent with the results of a 2014 survey of investor relations professionals who believe that activist investors can shorten the investment horizon of a public company and that longer investment horizons benefit shareholder value. See National Investor Relations Institute (NIRI) and the Rock Center for Corporate Governance at Stanford University, "2014 Study on How Investment Horizon and Expectations of Shareholder Base Impact Corporate Decision-Making," (2014).

<sup>10</sup> Ying Huang, Ningzhong Li, and Jeff Ng, "Performance Measures in CEO Annual Bonus Contracts," working paper, University of Texas at Dallas (June 2013).

<sup>11</sup> Heidrick & Struggles and the Rock Center for Corporate Governance at Stanford University, "2010 CEO Succession Planning Survey," (2010).

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**EXHIBIT 1 — RELATIVE CONTRIBUTION OF INVESTMENT RETURNS AND EARNINGS TO GROWTH****YARDSTICKS**

The first component of value is our investments: stocks, bonds and cash equivalents. At year end these totaled \$158 billion at market value. [...]

Berkshire's second component of value is earnings that come from sources other than investments and insurance underwriting. These earnings are delivered by our 68 non-insurance companies [...]. In Berkshire's early years, we focused on the investment side. During the past two decades, however, we've increasingly emphasized the development of earnings from non-insurance businesses, a practice that will continue.

The following tables illustrate this shift. In the first table, we present per-share investments at decade intervals beginning in 1970, three years after we entered the insurance business. We exclude those investments applicable to minority interests.

<u>Year</u>	<u>Per-Share Investments</u>	<u>Years</u>	<u>Compounded Annual Increase in Per Share Investments</u>
1970	\$ 66		
1980	754	1970-1980	27.5%
1990	7,798	1980-1990	26.3%
2000	50,229	1990-2000	20.5%
2010	94,730	2000-2010	6.6%

Though our compounded annual increase in per-share investments was a healthy 19.9% over the 40-year period, our rate of increase has slowed sharply as we have focused on using funds to buy operating businesses.

The payoff from this shift is shown in the following table, which illustrates how earnings of our non-insurance businesses have increased, again on a per-share basis and after applicable minority interests.

<u>Year</u>	<u>Per Share Pre-Tax Earnings</u>	<u>Years</u>	<u>Compounded Annual Increase in Per-Share Pre-Tax Earnings</u>
1970	\$ 2.87		
1980	19.01	1970-1980	20.8%
1990	102.58	1980-1990	18.4%
2000	918.66	1990-2000	24.5%
2010	5,926.04	2000-2010	20.5%

For the forty years, our compounded annual gain in pre-tax, non-insurance earnings per share is 21.0%. During the same period, Berkshire's stock price increased at a rate of 22.1% annually. Over time, you can expect our stock price to move in rough tandem with Berkshire's investments and earnings.

Source: Berkshire Hathaway, 2010 Annual Report.