

## WESCO FINANCIAL CORPORATION LETTER TO SHAREHOLDERS

### **To Our Shareholders:**

Consolidated net “operating” income (i.e., before realized investment gains shown in the table below) for the calendar year 2005 increased to \$77,973,000 (\$10.95 per share) from \$47,427,000 (\$6.66 per share) in the previous year.

Consolidated net income increased to \$294,579,000 (\$41.37 per share) from \$47,427,000 (\$6.66 per share) in the previous year.

Wesco has four major subsidiaries: (1) Wesco-Financial Insurance Company (“Wes-FIC”), headquartered in Omaha and engaged principally in the reinsurance business, (2) The Kansas Bankers Surety Company (“Kansas Bankers”), owned by Wes-FIC and specializing in insurance products tailored to midwestern banks, (3) CORT Business Services Corporation (“CORT”), headquartered in Fairfax, Virginia and engaged principally in the furniture rental business, and (4) Precision Steel Warehouse, Inc. (“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)<sup>(1)</sup>:

	Year Ended			
	December 31, 2005		December 31, 2004	
	Amount	Per Wesco Share <sup>(2)</sup>	Amount	Per Wesco Share <sup>(2)</sup>
Operating earnings:				
Wesco-Financial and Kansas Bankers insurance businesses —				
Underwriting .....	\$ 11,798	\$ 1.66	\$14,618	\$2.05
Investment income .....	39,068	5.49	26,302	3.69
CORT furniture rental business .....	20,676	2.90	5,022	.71
Precision Steel businesses .....	1,198	.17	1,094	.15
All other “normal” net operating earnings <sup>(3)</sup> .....	5,233	.73	391	.06
	<u>77,973</u>	<u>10.95</u>	<u>47,427</u>	<u>6.66</u>
Realized investment gains <sup>(4)</sup> .....	216,606	30.42	—	—
Wesco consolidated net income .....	<u>\$294,579</u>	<u>\$41.37</u>	<u>\$47,427</u>	<u>\$6.66</u>

(1) All figures are net of income taxes.

(2) Per-share data are based on 7,119,807 shares outstanding. Wesco has had no dilutive capital stock equivalents.

(3) Represents income from ownership of the Wesco headquarters office building, primarily leased to outside tenants, and interest and dividend income from cash equivalents and marketable securities owned outside the insurance subsidiaries, less interest and other corporate expenses.

(4) Includes \$216,112,000 (\$30.35 per share) from the tax-free exchange of Wesco’s common shares in The Gillette Company for common shares in The Procter & Gamble Company in connection with the merger of Gillette with Procter & Gamble. Although no cash was received, generally accepted accounting principles require that the gain be recorded. Because Wesco’s balance sheet reflects investments carried at market value, with unrealized gains, after applicable income tax effect, included in shareholders’ equity, the transaction did not affect Wesco’s shareholders’ equity. It merely resulted in a reclassification from unrealized gains to retained earnings, another component of shareholders’ equity.

This supplementary breakdown of earnings differs somewhat from that used in audited financial statements which follow standard accounting convention. The foregoing supplementary breakdown is furnished because it is considered useful to shareholders.

The total consolidated net income shown above is, of course, identical to the total in our audited financial statements.

## Insurance Businesses

Consolidated operating earnings from insurance businesses represent the combination of the results of their insurance underwriting (premiums earned, less insurance losses, loss adjustment expenses and underwriting expenses) with their investment income. Following is a summary of these figures as they pertain to all insurance operations (in 000s).

	<b>Year Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Premiums written .....	<u>\$50,253</u>	<u>\$45,042</u>
Premiums earned .....	<u>\$49,482</u>	<u>\$54,589</u>
Underwriting gain .....	\$14,566	\$22,490
Dividend and interest income .....	<u>55,889</u>	<u>36,058</u>
Income before income taxes .....	70,455	58,548
Income taxes .....	<u>19,589</u>	<u>17,628</u>
Total operating income — insurance businesses .....	<u>\$50,866</u>	<u>\$40,920</u>

Following is a breakdown of premiums written (in 000s):

Wes-FIC —		
Aviation pools .....	\$29,118	\$26,655
Property-casualty pool .....	—	(2,342)
Other .....	(64)	—
Kansas Bankers .....	<u>21,199</u>	<u>20,729</u>
Premiums written .....	<u>\$50,253</u>	<u>\$45,042</u>

Following is a breakdown of premiums earned (in 000s):

Wes-FIC —		
Aviation pools .....	\$28,391	\$27,944
Property-casualty pool .....	—	6,244
Other .....	(53)	29
Kansas Bankers .....	<u>21,144</u>	<u>20,372</u>
Premiums earned .....	<u>\$49,482</u>	<u>\$54,589</u>

Following is a breakdown of after-tax results (in 000s):

Underwriting gain —		
Wes-FIC .....	\$ 6,787	\$11,144
Kansas Bankers .....	<u>5,011</u>	<u>3,474</u>
	<u>11,798</u>	<u>14,618</u>
Net investment income —		
Wes-FIC .....	36,032	24,567
Kansas Bankers .....	<u>3,036</u>	<u>1,735</u>
	<u>39,068</u>	<u>26,302</u>
Total operating income — insurance businesses .....	<u>\$50,866</u>	<u>\$40,920</u>

As shown above, operating income includes significant net investment income, representing dividends and interest earned from marketable securities. However, operating income excludes investment gains of \$216.6 million, net of income taxes, realized in 2005. No investment gains or losses were realized in 2004. The discussion below will concentrate on insurance underwriting, not on the results from investments.

Wes-FIC engages in the reinsurance business, occasionally insuring against loss from rare but horrendous “super-catastrophes.” In much reinsurance sold by us, other Berkshire subsidiaries have sold several times as much reinsurance to the same customers on the same terms. In certain instances but not always, such subsidiaries have taken from us a 3%-of-premiums ceding commission on premium volume passed through them to Wes-FIC. Excepting this ceding commission, Wes-FIC has had virtually no insurance-acquisition or insurance administration costs. In some cases, other Berkshire subsidiaries act as reinsurers at higher levels than the level at which Wes-FIC is reinsuring; terms of the reinsurance are considered to be fair or advantageous to Wes-FIC.

For the past several years Wes-FIC’s reinsurance activity has consisted of the participation in two arrangements described below, the second of which was terminated in the fourth quarter of 2004:

- (1) Participation, since 2001, in several risk pools managed by an insurance subsidiary of Berkshire Hathaway, our 80%-owning parent, recently covering hull, liability and workers’ compensation exposures relating to the aviation industry as follows: for 2004, to the extent of 10% in the hull and liability pools; for 2005, 10% of the hull and liability pools and 5% of the workers’ compensation pool. For 2006, participation in the hull and liability pools has increased to 12½ %. The Berkshire subsidiary provides a portion of the upper-level reinsurance protection to these aviation risk pools on terms that could result in the Berkshire subsidiary having a different interest from that of Wes-FIC under certain conditions, e.g., in settling a large loss.
- (2) A multi-year contract entered into in 2000 through another Berkshire insurance subsidiary, as intermediary without profit, covering certain multi-line property and casualty risks of a large, unaffiliated insurer. This contract was commuted in the fourth quarter of 2004, at which time Wes-FIC paid the ceding company \$43.1 million, cash, representing all unearned premiums, reduced by unamortized costs and expenses. After the commutation, Wes-FIC’s obligation to indemnify any further insurance losses under the contract ceased. Under that contract for 2004, there was a net reduction in written premiums of \$2.3 million; earned premiums were \$6.4 million, and underwriting gain was \$11.0 million (\$7.2 million, after income taxes).

Wes-FIC’s underwriting results have fluctuated from year to year, but have been satisfactory. When stated as a percentage, the sum of insurance losses, loss adjustment expenses and underwriting expenses, divided by premiums, gives the combined ratio. The combined ratios of Wes-FIC have been much better than average for insurers. Excluding the unusual beneficial effects caused by the commuted contract in 2004, Wes-FIC’s combined ratios were 75.9% for 2005 and 77.8% for 2004. Although we have an appetite for unusually large risks when prices are satisfactory, thus subjecting

Wes-FIC to significant periodic underwriting losses, we try to create some underwriting gain as results are averaged out over many years.

Kansas Bankers was purchased by Wes-FIC in 1996 for approximately \$80 million in cash. Its tangible net worth now exceeds its acquisition price, and it has been a very satisfactory acquisition, reflecting the sound management of President Don Towle and his team.

Kansas Bankers was chartered in 1909 to underwrite deposit insurance for Kansas banks. Its offices are in Topeka, Kansas. Over the years its service has continued to adapt to the changing needs of the banking industry. Today its customer base, consisting mostly of small and medium-sized community banks, is spread throughout 30 mainly midwestern states. In addition to bank deposit guaranty bonds which insure deposits in excess of FDIC coverage, KBS offers directors and officers indemnity policies, bank employment practices policies, bank insurance agents professional errors and omissions indemnity policies and Internet banking catastrophe theft insurance.

KBS increased the volume of business retained effective in 1998. It had previously ceded almost half of its premium volume to reinsurers. Now it reinsures only about 13%. The increased volume of business retained comes, of course, with increased irregularity in the income stream. KBS's combined ratios were 58.8% for 2005 and 74.9% for 2004. We continue to expect volatile but favorable long-term effects from increased insurance retained.

### **CORT Business Services Corporation ("CORT")**

In February 2000, Wesco purchased CORT Business Services Corporation ("CORT") for \$386 million in cash.

CORT is a very long established company that is the country's leader in rentals of furniture that lessees have no intention of buying. In the trade, people call CORT's activity "rent-to-rent" to distinguish it from "lease-to-purchase" businesses that are, in essence, installment sellers of furniture.

However, just as Hertz, as a rent-to-rent auto lessor in short-term arrangements, must be skilled in selling used cars, CORT must be and is skilled in selling used furniture.

CORT's revenues totaled \$384 million for calendar 2005, versus \$354 million for calendar 2004. Of these amounts, furniture rental revenues were \$304 million and \$275 million, furniture sales revenues were \$72 million and \$68 million, and apartment locator fees of its Relocation Central division, a business CORT started up in 2001, were \$8 million and \$11 million. CORT operated at an after-tax profit of \$20.7 million for 2005, up satisfactorily from its after-tax profit of \$5.0 million for 2004. These results reflect the favorable effects of several selective acquisitions.

When we purchased CORT early in 2000, its furniture rental business was rapidly growing, reflecting the strong U.S. economy, phenomenal business expansion and explosive growth of IPOs and the high-tech sector.

Beginning late in 2000, however, new business coming into CORT began to decline. With the burst of the dot-com bubble, the events of September 11, and a protracted slowdown in new business formation, CORT's operations were hammered,

reflecting generally bad results in the “rent-to-rent” segment of the furniture rental business. Obviously, when we purchased CORT we were poor predictors of near-term industry-wide prospects of the “rent-to-rent” sector of the furniture business.

CORT started up a new subsidiary during 2001, Relocation Central, which provides a large national apartment locator service through its websites, ([www.relocationcentral.com](http://www.relocationcentral.com) and [www.myrelocationcentral.com](http://www.myrelocationcentral.com)), customer call centers and walk-in locations. This start-up venture did not progress as rapidly as CORT expected and caused losses followed by some downsizing. Relocation Central was reorganized to become a division of CORT as of yearend 2004; it now relies more on Internet traffic and less on separate, fully-staffed facilities. The integration of Relocation Central into CORT was begun in 2003 as part of a program to reduce CORT’s costs and thus enhance its operating results. CORT still likes the idea of having relocation services in its product mix. Almost twenty thousand apartment communities now refer their tenants to CORT.

We are pleased with the progress CORT made in 2005. We are cautiously optimistic that, in future years, we will be able to look back to the recent past and consider it merely a cyclical aberration in CORT’s growth. We note, however, that the number of furniture leases outstanding as of yearend 2005 has fallen by about 4% from those one year earlier.

When Wesco paid \$386 million for CORT, about 60% of the purchase price was attributable to goodwill, an intangible balance sheet asset. Wesco’s consolidated balance sheet now contains about \$267 million in goodwill (including \$27 million from Wesco’s 1996 purchase of KBS). The Financial Accounting Standards Board adopted a rule which became effective in 2002 that no longer requires automatic amortization of acquired goodwill. (The requirement for such amortization has been replaced by a standard that requires an annual assessment to determine whether the value of goodwill has been impaired, in which event the intangible asset would be written down or written off, as appropriate.) Earnings we have reported since 2002 more closely reflect microeconomic reality as we appraise it.

More details with respect to CORT are contained throughout this annual report, to which your careful attention is directed.

CORT has long been headed by Paul Arnold, age 59, who is a star executive as is convincingly demonstrated by his long record as CEO of CORT. We are absolutely delighted to have Paul and CORT within Wesco.

### **Precision Steel Warehouse, Inc. (“Precision Steel”)**

The businesses of Wesco’s Precision Steel subsidiary, headquartered in the outskirts of Chicago at Franklin Park, Illinois, operated at after-tax profits of \$1.2 million in 2005 and \$1.1 million in 2004. These figures reflect after-tax LIFO inventory accounting adjustments decreasing after-tax income by \$.2 million for 2005 and \$1.8 million for 2004. Precision Steel’s operating results for 2004 also reflect expenses of \$.2 million, after taxes, in connection with environmental cleanup of an industrial park where a Precision Steel subsidiary has operated alongside approximately 15 other manufacturers for many years. Had it not been for the LIFO accounting adjustment or the environmental matter, Precision Steel would have reported after-tax operating income of \$1.3 million for 2005 and \$3.0 million for 2004.

Precision Steel's business has been subject to economic cycles. Precision Steel has increasingly suffered from intensified competition resulting from a reduction in demand caused by customers' (or former customers') unsuccessful competition with manufacturers outside the United States. At the beginning of 2004, a shortage of raw materials from domestic mills produced near chaos in the domestic steel service industry. Domestic mills were operating at capacity and imported steel was not readily available. These and other factors enabled steel mills to raise prices, place limits on order quantities and extend delivery times. Prices of those raw materials were sharply increased and the price of finished steel also increased sharply. Customers of Precision Steel increased their purchases to counter allocations imposed by mills and other suppliers. Precision Steel successfully passed the price increases, plus normal mark-ups, on to customers while favoring long-term customer relationships. Precision Steel's 2004 revenues increased 31.2% from those of 2003; pounds of steel products sold increased 14.5%. Throughout 2005, raw material supplies remained very tight, but competitive pressures increased as demand softened, possibly reflecting customers' absorption in their manufacturing processes of accelerated purchases made in 2004 in reaction to the chaotic market conditions. In 2005, pounds of steel products sold by Precision Steel decreased 8.6% from those of 2004, but revenues increased 1.4%, reflecting mainly 40%-higher average selling prices than those prevailing two years earlier. We are concerned that the favorable operating results experienced by Precision in the two most recent years may have been anomalous and temporary and that the steel warehouse business may revert to difficult times.

Although Precision Steel's figures for each of the past two years may signal improvement when compared with its after-tax operating loss of \$.9 million for 2003 and \$.3 million of income for 2002, it should be noted that conditions currently facing the steel service industry continue to be in a state of flux. The severity of the domestic downturn in the steel service industry is demonstrated by the fact that Precision Steel's average annual steel service revenues for the years 2001 through 2003 were down 27% from those reported for 1998 through 2000. Considering the improved earnings for 2004 and 2005, Precision Steel has still not reported satisfactory operating results in recent years. Its recent earnings compare unfavorably with operating profits which averaged \$2.3 million, after taxes, for the years 1998 through 2000.

Terry Piper, who became Precision Steel's President and Chief Executive Officer in 1999, has done an outstanding job in leading Precision Steel through very difficult years.

### **Tag Ends from Savings and Loan Days**

All that now remains outside Wes-FIC but within Wesco as a consequence of Wesco's former involvement with Mutual Savings, Wesco's long-held savings and loan subsidiary, is a small real estate subsidiary, MS Property Company, that holds tag ends of appreciated real estate assets consisting mainly of the nine-story commercial office building in downtown Pasadena, where Wesco is headquartered. Adjacent to that building is a parcel of land on which we have begun to build a multi-story luxury condominium building. We are also seeking city approval of our plans to build another multi-story luxury condominium building on a vacant parcel of land in the next block. We have recently begun to take reservations. Simply phone Bob Sahn (626-585-6700) for more information. MS Property Company's results of operations, immaterial versus Wesco's present size, are included in the breakdown of earnings on page 1 within "other operating earnings."

## **Other Operating Earnings**

Other operating earnings, net of interest paid and general corporate expenses, amounted to \$5.2 million in 2005, up from the \$.4 million earned in 2004. Ignoring favorable income tax adjustments of \$4.9 million, the sources of the \$.3 million of earnings in 2005 were (1) rents (\$3.5 million gross in 2005) from Wesco's Pasadena office property (leased almost entirely to outsiders, including Citibank as the ground floor tenant), and (2) interest and dividends from cash equivalents and marketable securities held outside the insurance subsidiaries, less (3) general corporate expenses plus minor expenses involving tag-end real estate.

## **Realized Investment Gains**

Wesco's 2005 earnings contained investment gains of \$216.6 million, after income taxes. There were no realized investment gains in 2004. Of the 2005 gains, only \$.5 million was realized through the *sale* of investments; the balance, \$216.1 million, resulted from the tax-free exchange of common shares of The Gillette Company ("Gillette") owned by Wesco, for common shares of The Procter & Gamble Company ("P&G") in the fourth quarter of 2005 in connection with the merger of Gillette with P&G. Accounting standards promulgated by the Financial Accounting Standards Board require that the fair (market) value of shares received in such an exchange be recorded as the new cost basis as of the date of the exchange, with the difference between the new basis and the historical cost realized in the audited financial statements as an investment gain. For tax return purposes the exchange is recorded at the original cost of the securities exchanged; no gain is reported, and no taxes are yet due.

Although the realized gain had a material impact on Wesco's reported earnings, *it had no impact on Wesco's shareholders' equity*. Wesco carries its investments at fair value, with unrealized appreciation, after income tax effect, included as a separate component of shareholders' equity, and related taxes included in income taxes payable, on its consolidated balance sheet. Thus, the entire after-tax gain on the non-cash merger had been reflected in the unrealized gain component of Wesco's shareholders' equity as of September 30, 2005. That amount was merely switched from unrealized gain to retained earnings, another component of shareholders' equity. This accounting entry had no economic effect on Wesco, and you should ignore it when you are evaluating Wesco's 2005 earnings.

## **Consolidated Balance Sheet and Related Discussion**

As indicated in the accompanying financial statements, Wesco's net worth, as accountants compute it under their conventions, increased to \$2.23 billion (\$313 per Wesco share) at yearend 2005 from \$2.12 billion (\$297 per Wesco share) at yearend 2004. The main cause of the increase was net operating income after deduction of dividends paid to shareholders.

The foregoing \$313-per-share book value approximates liquidation value assuming that all Wesco's non-security assets would liquidate, after taxes, at book value.

Of course, so long as Wesco does not liquidate, and does not sell any appreciated securities, including the P&G shares Wesco received in connection with P&G's acquisition of Gillette, discussed above in the section, "Realized Investment Gains," Wesco has, in effect, an interest-free "loan" from the government equal to its deferred income taxes, subtracted in determining its net worth. This interest-free "loan" from

the government is at this moment working for Wesco shareholders and amounted to about \$36 per Wesco share at yearend 2005.

However, some day, parts of the interest-free “loan” may be removed as securities are sold. Therefore, Wesco’s shareholders have no perpetual advantage creating value for them of \$36 per Wesco share. Instead, the present value of Wesco’s shareholders’ advantage must logically be much lower than \$36 per Wesco share.

Business and human quality in place at Wesco continues to be not nearly as good, all factors considered, as that in place at Berkshire Hathaway. Wesco is not an equally-good-but-smaller version of Berkshire Hathaway, better because its small size makes growth easier. Instead, each dollar of book value at Wesco continues plainly to provide much less intrinsic value than a similar dollar of book value at Berkshire Hathaway. Moreover, the quality disparity in book value’s intrinsic merits has, in recent years, continued to widen in favor of Berkshire Hathaway.

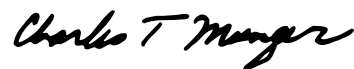
All that said, we make no attempt to appraise relative attractiveness for investment of Wesco versus Berkshire Hathaway stock at present stock-market quotations.

Wesco’s consolidated balance sheet reflects total assets of \$2.7 billion as of yearend 2005. Of that amount, more than \$1 billion has been invested in cash equivalents and fixed-maturity investments since early in 2003. Unless those funds can be attractively reinvested in acquisitions, equity securities or other long-term instruments of the type that have been responsible for the long-term growth of Wesco’s shareholders’ equity, future returns on shareholders’ equity will probably be less than those of the past. Due to the current size of Wesco and its parent, Berkshire Hathaway, Wesco’s opportunities for growing shareholders’ equity are unlikely to be as attractive as in the past.

The Board of Directors recently increased Wesco’s regular dividend from 35½ cents per share to 36½ cents per share, payable March 2, 2006, to shareholders of record as of the close of business on February 1, 2006.

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.

Shareholders can access much Wesco information, including printed annual reports, earnings releases, SEC filings, and the websites of Wesco’s subsidiaries and parent, Berkshire Hathaway, from Wesco’s website: [www.wescofinancial.com](http://www.wescofinancial.com).



Charles T. Munger  
Chairman of the Board  
and President

March 2, 2006