Pension accounting

Murk in the gloom

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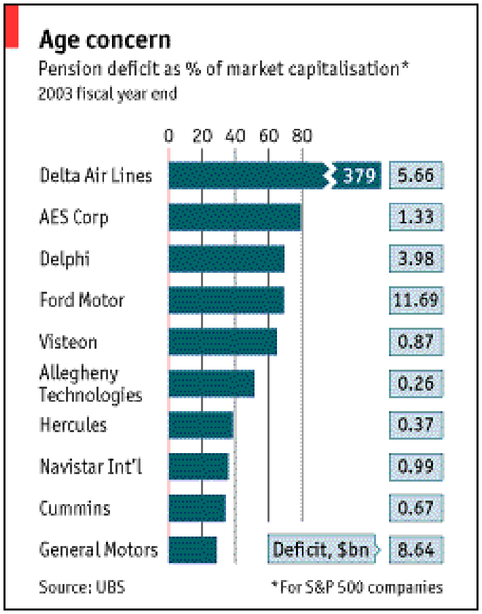
An SEC investigation will shine much-needed light on the sorry state of accounting for retiree benefits



WHEN you think of General Motors (GM) or Ford, you think of cars. But these days when the Securities and Exchange Commission (SEC) considers these companies, it is looking at pensions—and the sundry esoteric assumptions that go into accounting for them. In late October, it emerged that the SEC was investigating how GM, Ford and four other firms (Delphi, Northwest, Navistar and Boeing) account for their retiree benefits. None has been accused of wrongdoing; but the SEC's interest was piqued by the companies' enormous pension deficits (Ford's alone was $3.5 billion in 2003), by the sensitivity of company profits to swings in the value of these liabilities and by, in the words of one official, “the potential for mischief”.

This potential exists because companies have great flexibility in measuring the size of pension obligations and assets, and hence the pension deficits or surpluses that feed into profits. Some of this leeway is unavoidable. A company's retiree obligations are promises that have to be delivered in the future; measuring the size of these obligations involves tricky and subjective judgments, such as how long employees will work, when they will die, and how much health care they will need.

But pension accounting takes this inherent fuzziness and makes it unnecessarily fuzzier. It does this by letting companies “smooth” the swings in the value of pension assets (which move around with financial markets) and liabilities (which move mainly with interest rates). This smoothing distorts the true health of companies' balance sheets and their profits.

The distortions can be huge, particularly for companies where pension deficits or surpluses are large compared with their size (see chart), because the volatility of financial markets will have a bigger relative impact on the profits of such companies. Shareholders in firms with relatively large pension deficits should pay especial attention to these distortions, because the claims of pension-holders are superior to those of shareholders, and pension deficits can trigger accelerated pension-fund contributions that will come out of profits.

Smooth operators

Perhaps the most egregious way in which companies smooth profits is by valuing pension assets using expected rather than actual returns. They are allowed to do this because the assets are invested to meet pension promises in the distant future, so they can dismiss short-term swings. But whether because they are inherently optimistic, or because they wish to hide the true state of their pension plans, companies generally expect unrealistically high returns. This reduces their obligations to the pension fund and thus inflates their own profits.

Regulators have pressured companies to lower these estimates for years, with only limited success. According to Morgan Stanley, the expected average annual return used by firms in the S&P 500 index fell from 9.5% in 2001 to 8.6% in 2003 . But even these lower assumptions seem extraordinarily optimistic. And UBS reckons that about $2 of such companies' earnings per share of some $55 in 2003 was still due to aggressive pension-return assumptions.

Morgan Stanley reckons that for funds to make their 8.6% target, their equity returns would need to exceed 11% a year over the long term because almost half of these firms' pension assets are invested in lower-yielding bonds. Such consistently high performance is unlikely given that rich-country stockmarkets are so generously valued. “Allowing companies to use expected returns was never smart—but doing so is peculiarly irrational and dangerous at the moment,” says Andrew Smithers of Smithers & Co, a consultancy.

What worries the SEC and many investors is that using assumed returns, particular high ones, is at best incredibly misleading and at worst gives firms the flexibility to manipulate earnings. A recent study by Mihir Desai and Daniel Bergstresser of Harvard Business School, and Joshua Rauh of the University of Chicago, finds evidence of just such tinkering. Their analysis of 3,247 company pension plans from 1991-2002 found that firms tended to boost pension-return assumptions the year before buying a company, or before their chief executive exercised his stock options.

Others fret, more fundamentally, that this flexibility can skew how companies allocate pension assets. For the more they put their pension money into riskier assets such as equities, the higher the returns they can assume for the purposes of generating today's profits.

Another assumption that has caught the SEC's eye is the discount rates used by companies to value pension liabilities. The higher the rate, the lower the present value of pension obligations and the lower the pension expense. The SEC has issued guidance that high-quality corporate bond yields are a good starting point for setting this rate. But only a starting point.

In particular, adjustments should be made for a company's circumstances. For example, a firm with many retirees and a rapidly ageing workforce should use a lower discount rate than, say, its upstart competitor with a young workforce, because the older firm will have to pay its benefits sooner. But the discount rates used by companies cluster tightly around the 6-6.5% range.

Given the huge leeway companies have in setting expected returns and discount rates, and the complexity of the task, it is, perhaps, little wonder that actual pension deficits or surpluses are bigger or smaller than the companies had thought they might be. But rather than reflect this immediately, pension accounting rules again allow companies to manipulate these figures still further by putting them onto the income statement (profit-and-loss account in Britain) over many years.

This leads to results that are, to put it mildly, counterintuitive. For example, even though pension plans of S&P 500 companies did well last year, with returns of 20%, their net pension expenses leapt to $27.5 billion, 11.5 times more than the previous year. Why? Because the $321 billion in “unrecognised” pension losses that were sitting off their balance sheets—thanks to the dismal stockmarket performance of previous years—only started seeping onto income statements in 2003.

Just as strangely, these delays in bringing losses and gains onto corporate balance sheets can produce what has been dubbed “false income”—ie, an addition to the company's profits even while its pension fund remains deeply in deficit. True, the number of firms that are claiming such false income is declining: last year, only 25 of the S&P 500 companies with pension plans reported this phantom profit, compared with 60 the previous year. But the list includes big names, such as IBM, Lucent and Dow Chemical. And the extraordinary thing is that it happens at all.

"Pension accounting is broken," says David Bianco of UBS. Like many others, he argues that assets and obligations should be shown at market value immediately—rather than delayed and smoothed. Critics of such a transparent approach argue that the necessary information exists in the footnotes to financial statements, particularly since last December, when the American standard-setter boosted disclosure requirements for pensions. Moreover, they say, thrusting volatile market values on financial statements will confuse investors.

But what is the point of financial statements if they are not meant to reflect economic reality? Volatility in pension assets is real—even if it is not reported. And, despite the rosy assumptions of actuaries, stockmarkets can fall a long way and for a long time before they recover. The Japanese stockmarket is still only a quarter or so of the level it reached 14 years ago.