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How Corporate Pension Plans Affect Earnings: a Primer

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NEW YORK -- If you're confused about some of the recent news on corporate pension plans, don't get discouraged. The nuances of how companies account for their pension plans are enough to give anyone a headache.

In recent months, there's been a sometimes-bewildering array of news about problems with pension plans. Many companies have indicated that they're expecting their earnings to fall because of increasing pension costs. Some are pumping more money into their underfunded pension plans, or taking pension-related balance-sheet charges. Last week The Wall Street Journal reported that **General Electric Co.**, pressured by a shareholder proposal, agreed to exempt pension income when determining the earnings on which it bases the pay of its top executives.

All of this raises a number of questions regarding how pension-plan results affect a company's earnings and why the financial condition of pension plans has become a major issue.

Q: How does a company calculate its pension income?

A: A company's pension income is calculated by taking the pension plan's assets and applying the rate of return the company anticipates on its pension plan -- about 8% or higher at many companies. That figure then gets balanced against the costs of servicing the plan, which then is modified further in some cases by gains or losses incurred in previous years -- but more on that issue later.

The resulting pension-income figure then is factored into a company's earnings statement, typically as part of sales, general and administrative expenses. If pension income is positive, it shows up as a reduction in

sales, general and administrative expenses, although it usually isn't broken out as a separate line item. At some companies, the income generated by pension plans can be a very significant percentage of earnings.

Q: Does this happen at all companies with retirement plans?

A: No. It applies only to companies with "defined-benefit" plans, or those in which retirees receive a guaranteed payment from the company each month after they retire. "Defined-contribution" plans like 401(k) accounts, in which companies make contributions to an employee's retirement account but the amount a retiree receives isn't guaranteed, don't feed into earnings.

Q: If companies have been using their own "anticipated" rates of return of 8% or higher in calculating pension income, doesn't that mean they've been far too optimistic about the market in the past few years? And have the use of those overly rosy assumptions thereby enabled companies to boost their pension income, and thus their overall earnings?

A: That's right. Under current pension accounting rules, companies can essentially set their own rate of return for the purpose of computing pension income, no matter how their plan has actually performed. To take one example of many, **Norfolk Southern Corp.** has a 9% annual expected rate of return on pension assets, even though its pension assets actually lost 11% in 2002. Until recently, that has allowed some companies to record much higher pension income than the market performance of their plans would seem to dictate, and that has increased their earnings.

Norfolk Southern and other companies argue that their anticipated rates of return are meant to reflect the annualized long-term performance of their pension plans rather than any one year's fluctuation. "We don't want to overreact to current market conditions," a Norfolk Southern spokesman said.

But as the market's downturn goes on and on, that argument may be losing its force, and regulators have taken notice of the issue. The Securities and Exchange Commission has indicated that it will scrutinize any company whose expected pension rate of return seems excessive.

Q: Besides the expected rates of return, and the costs of servicing the plan, what other factors influence pension income?

A: Pension accounting provides that companies set aside some of their pension gains or losses under certain circumstances. Those items are then gradually factored into pension income -- and thus into earnings -- in future years. It's called "smoothing," and it's intended to reduce year-to-year earnings volatility.

Along with the effect of too-rosy assumptions about return rates, this delaying and smoothing effect is why pension income has only recently started to suffer even though the market has been declining since 2000: Companies piled up big pension gains from the 1990s market boom, and some of them helped prop up pension income for some time even after the boom ended. But delaying and smoothing can cut both ways: The current market downturn likely will weigh on earnings even after it ends, as losses incurred now get amortized into pension income in the future.

Q: Why are companies pumping so much money into their pension plans right now?

A: Because pension plans are becoming underfunded to an increasing degree -- that is, their assets aren't enough to meet their projected benefit obligations. For one thing, the value of pension assets is being

eroded by the stock market's downturn. For another, pension liabilities are increasing because interest rates have declined and are staying low -- low rates have the effect of increasing the current value of pension plans' future obligations to pay retirees. **General Motors Corp.** and **International Business Machines Corp.** are among the companies that have recently contributed to their pension plans.

The mere fact that a plan is underfunded doesn't by itself mean that a company has to put more money into it. Under the Employee Retirement Income Security Act, or Erisa, which governs companies' pension contributions, a company doesn't have to inject more money into its plan if it did so this year or last. But many companies want to do so to prevent any problems with loan covenants, higher insurance premiums or balance-sheet charges.

Q: What about those balance-sheet pension charges so many companies have taken recently? Why are they taking them? Does that affect earnings?

A: Not directly. The "charges" are actually reductions in shareholder equity on the company's balance sheet. This comes about when a company's pension plan is so underfunded that its assets aren't enough to meet its obligations to retirees even when measured at current salary levels -- much less than projected future salary levels, which presumably would be higher. Under those circumstances, the Internal Revenue Service requires companies to add a liability to their balance sheet, resulting in the reduction of shareholder equity.

Q: Where can I find out more about a company's pension plan and its results and assumptions?

A: Right now, there's only one guaranteed source for the information -- the company's 10-K annual report filed with the SEC. That's the only place companies must disclose the calculation of their pension income and the assumptions they're using in order to do it.

There is a move afoot to require more frequent disclosure, however, although nothing has been done as of yet. And the Financial Accounting Standards Board has indicated that it may revisit the issue of pension accounting with an eye toward overhauling it.

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