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A Pension Rule, Sometimes Murky, Is Under Pressure

By [MARY WILLIAMS WALSH](#)

Herb Zydney, who retired as an [AT&T](#) executive in 1996, is worried about his pension. Switched into [Lucent Technologies'](#) retirement plan during its spinoff from AT&T, he complains that Lucent has invested in "a bunch of risky stuff," in part because of an accounting provision that gives it a financial incentive to do so.

Lucent has already been through one wrenching financial crisis, in the early 2000's, and should its pension plan fail, Mr. Zydney would lose a big part of his benefit. "But I'm almost more concerned as an investor than I am as a retiree," added Mr. Zydney, 72, who owns Lucent stock in a self-directed individual retirement account.

When Lucent issues its 1 results each year, it factors in assumptions about its pension fund - assumptions that have padded its earnings. In 2004, for instance, Lucent said it earned \$1.2 billion from operations, but \$1.1 billion of that actually resulted from pension calculations.

This week, the Financial Accounting Standards Board, which writes the accounting rules for American business, will decide whether to go ahead with plans to change the way pension accounting is done.

The board's current rule is 20 years old and has drawn fire from retirees and investors for many of the same reasons that disturb Mr. Zydney, who has made his concerns about his Lucent pension into something of a crusade.

"Right now, the stuff isn't transparent," Mr. Zydney said. "There's no accuracy. No consistency. And everybody's trying to play some financial game to make things look better."

Lucent said that its plan was healthy and that retirees' fears were unwarranted. A spokesman, William Price, also said that the company had tried to disclose as clearly as possible what part of its income came from its business operations and what part from the pension fund.

Not that everyone welcomes a pension accounting change. A yes vote by the accounting board on

Thursday could set off a long battle, like the 10-year fight over how companies should account for stock-option grants.

Billions of dollars are at stake. And no one expects companies to readily give up a tool that can enhance earnings - the bottom line that determines, among other things, their executive bonuses.

Companies with pension funds say a change in the accounting rule would probably make them show more of the day-to-day volatility of their pension investments, something the current rule lets them keep out of sight through a process called smoothing.

Showing the volatility, and the way it can affect the business, would probably discourage investors, companies say. To quiet investor concerns, they say that they may have to shut down their pension plans entirely.

That would get rid of the volatility, to be sure, but it would also hasten the demise of a valuable benefit that still covers tens of millions of Americans.

The last time the accounting board considered rewriting the pension rule, in March 2003, a majority of the members voted against it. Since then, however, big investors and others have urged the board to try again.

The biggest complaint about the current rule is that it directs companies, at the beginning of each year, to make an educated guess about their pension funds' investment returns, and then, at the end of the year, factor that assumption into corporate profits, no matter what the year's actual returns turned out to be.

"If you need to manufacture profits, this is just an incredibly convenient technology," said Mihir A. Desai, an associate professor of finance at the Harvard Business School.

Professor Desai based his assertion on a study of the behavior of more than 3,000 companies over 11 years, which he conducted with Daniel B. Bergstresser of the Harvard Business School and Joshua D. Rauh of the Massachusetts Institute of Technology.

The researchers found that companies tended to ratchet up their assumptions of pension fund returns, padding their profits just before certain corporate events, like acquisitions, secondary stock offerings or the exercise of stock options by executives - all times when a higher stock price is desirable. The study is to be published in *The Quarterly Journal of Economics*.

Companies are required to administer their pension plans for the sole benefit of their employees and retirees, and they are quick to dispute suggestions that they may be deliberately using their pension funds to manipulate earnings. They say that they are merely following the accounting rule, and that the rule is valid because a pension fund is a long-term proposition that should not be judged on a quarter-to-quarter basis, the way its corporate sponsor is.

But major investors and regulators point to what they consider too many jarring examples of pension accounting that seem totally detached from economic reality.

Last summer, the Securities and Exchange Commission said that it had studied a sample group of companies and found that they had told their shareholders they had an aggregate surplus of \$91 billion in their pension funds, when a more honest accounting would have shown an aggregate deficit of \$86 billion.

David Zion, an analyst at Credit Suisse First Boston, identified half a dozen big companies that reported profits in 2003 that would have been forced to report losses if they had used their real pension numbers instead of projections. Using the smoothed numbers instead of the real ones, Mr. Zion said, "is the equivalent of your depositing a paycheck for what you think you should get paid instead of what you were actually paid."

At FedEx, for instance, a reported profit of \$830 million became an \$87 million loss when Mr. Zion stripped out the smoothed pension numbers and put in the real ones for that year. Boeing's \$718 million reported profit became a \$158 million loss. The other four companies whose pension funds made the difference between a profit and a loss in 2003 were Parker-Hannifin, J. C. Penney, Rockwell Collins and Tektronix.

Mr. Zion said FedEx and Boeing were on different fiscal years than most other companies, and that had compounded the way their pension numbers distorted their income in 2003.

Boeing declined to comment on Mr. Zion's research. FedEx pointed out in an e-mail message that using assumed pension returns rather than actual returns was a requirement of the accounting rules, and that its financial statements complied with those rules.

"Our estimates," FedEx added, "have been consistent with the actual long-term performance of our pension assets."

Mr. Zion also looked at the cumulative effect of pension smoothing from 1999 through 2003, and found that it had inflated the total profit of the companies in the Standard & Poor's 500-stock index by about 15 percent.

Most affected was I.B.M., he found; its reported earnings for those five years fell to \$21 billion, from \$36 billion, once the pension effect was removed.

General Motors was next, with a reported five-year profit that fell to just \$1 billion, rather than \$15 billion, without the pension effect.

The big discrepancies appear to have caught the attention of the S.E.C. Last month, General Motors

disclosed that the S.E.C. had served it with a subpoena in connection with its pension calculations. It did not elaborate, but said it was cooperating with the commission.

The S.E.C. does not discuss investigations of individual companies. But it has issued general public warnings that it will challenge companies found to be factoring unusual assumptions into their pension calculations.

Companies assuming that their pension funds will return more than 9 percent per year have been told they will have to provide justification. Last year, FedEx, [Northwest Airlines](#), Eli Lilly and [Weyerhaeuser](#) were among the companies with assumptions over 9 percent.

Lucent brought its discount rate below 9 percent in 2003 and has said it will base its 2005 calculations on an 8.5 percent return. But even at that level, its pension calculations continue to play a big role because the fund is so large compared with the size of the company. The pension fund had assets of \$32 billion at the end of Lucent's fiscal 2004, which ended on Sept. 30. Lucent itself has a market value of about \$12 billion.

In 1997, Lucent's first full year of operations, 20 percent of its operating income came from the pension effect. In 1998, 29 percent did. That year, Lucent's chief executive, Richard A. McGinn, was given an extra \$7.4 million bonus "in recognition of outstanding performance," on top of a regular bonus of \$4.4 million, base pay of \$1.1 million and an array of stock options, restricted stock and perks.

In 1999, Lucent started calculating its pension investments in a new way, one that amplified the effect on earnings. Mr. McGinn got a cash bonus of \$4.1 million that year, which the company attributed to his success in increasing revenue and income. Beyond his base pay, he also received a supplemental award of \$1.7 million that year, because of a three-year performance benchmark that had been established in 1996.

Mr. Price, the spokesman for Lucent, said that many factors buoyed the company's earnings and stock price in the late 1990's, and that the company excluded the effect of pension accounting as a factor when determining executive compensation. He said that Lucent made that practice a formal policy in 2003.

Lucent's sales of telecommunication equipment nose-dived in 2000 and its stock price collapsed. Mr. McGinn was ousted at the end of the fourth quarter, when Lucent's operating income for the year fell by about half, to \$2.4 billion. The S.E.C. began investigating Lucent's accounting, particularly for the way it recognized revenue.

But even in 2000, about 40 percent of the reported operating income, \$951 million, was the result of pension calculations.

Mr. Zydney and a group of other retirees, meanwhile, began to worry about the pension fund. After many requests, they were given a list of its investments as of December 2003. The fund was fairly aggressively invested, leading Lucent to project a 8.75 percent annual return.

The retirees were dismayed to learn that the plan had about 8 percent of its assets in private equities and other so-called alternative investments. Mr. Zydney said he and his fellow retirees were concerned about the private investments because they are not traded on a market, cannot be sold easily and have no agreed-upon published price.

"The trouble with these investments, in part, is they're almost impossible to audit," Mr. Zydney said. "So you don't know how much money there is."

Mr. Price, the Lucent spokesman, said that the company's board decided which asset classes the pension fund would invest in, and that its decisions were prudent and "entirely in line with those of other major corporate pension plans." The actual investment process is the responsibility of a wholly owned subsidiary of Lucent known as Lamco.

"Lamco staff members act as fiduciaries for plan investments," Mr. Price said. He added that their compensation depended on how well the pension investments performed relative to external benchmarks, and was not connected with Lucent's financial results.

Mr. Zydney said his group was still concerned. "I've spoken to fiduciaries of the Lucent pension fund for hours and hours," he added. "They're all honest people, but the very nature of what they have to do is conflicted."

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