

Monday, December 9, 2002

## Pension Scheme

### Contributions to underfunded plans will actually boost some companies' future profits

By CHERYL STRAUSS EINHORN

When [International Business Machines](#) announced last week that it would double this year's planned contribution to its pension fund, to \$3 billion, Chief Financial Officer John Joyce emphasized the move wouldn't hurt the computer giant's 2003 earnings. What he didn't mention was that this step to shore up IBM's under-funded pension plan will actually boost the computer giant's bottom line by over a quarter billion dollars next year.



David Klein

How is that possible? After all, investors have grown increasingly fearful about the bear market's impact on corporate pension plans. After years of record equity returns left most plans fully funded, or even overfunded, many companies now face the need to make massive contributions to make up shortfalls in those plans caused by three down years in the stock market.

But what is less recognized is that companies that make those contributions will realize an increase -- yes, an increase -- to future earnings. It's an ironic, even bizarre result of pension-accounting rules. Even though the economic impact of topping up deficient plans is clearly negative -- shifting resources from shareholders to the pension plan -- the headline earnings numbers that grab investors' attention will look better.

"When a company makes a contribution to its [pension] plan...it has taken away cash from its coffers...and it is denied the interest income on that money," explains Itzhak Sharav, an accounting professor at the Columbia University

Business School. "But that [foregone] income is much lower than the assumed rate of return over time anticipated on the plan assets. Bottom line: a boost in [operating] income."

"It boosts income," agrees Jack Ciesielski, publisher of the Analyst's Accounting Observer, a newsletter covering accounting issues that frequently is critical of the quality of earnings numbers. "When you make a cash contribution, all else being equal, it lowers pension expense because of the expected rate of return on the incremental assets added by the contribution."

"If you are a believer in headline earnings, this doesn't matter to you. But if you are someone who cares about the underlying business of a firm, it is a concern and you have to strip it out."

At IBM, the company plans to contribute \$3 billion, split evenly between cash and common stock, by year-end. Based on IBM's assumed rate of return of 8.5% on its pension assets, that contribution would yield a \$255 million (\$3 billion multiplied by 8.5%) decrease in pension expense next year. That, in turn, would translate to an equal increase in operating income next year over what IBM would have earned without having made the contribution.

More important, the entire benefit counts as a reduction of operating expense, creating the appearance of a fundamental improvement in the business's performance. The irony is that as resources are diverted from shareholders, creditors or

reinvestment opportunities toward paying out future retiree benefits, the company gets to show improved earnings.

Companies don't like to advertise this. A [Pepsico](#) spokesperson admits "it is a valid statement that if we had not funded our pension assets by \$750 million this year, our pension expense would have been even higher than our estimated \$140 million-\$150 million next year." But she adds "it does not make sense to us to look at this one facet of net pension expenses in isolation of the total impact."

Unlike weaker companies, the computer giant has the financial muscle to be able to make this contribution to its pension fund. IBM previously had planned to contribute \$1.5 billion a year for three years, a total of \$4.5 billion. The stock rally since early October trimmed the needed contribution to \$3 billion, so the company decided to take care of it in one fell swoop.

Be that as it may, the pension-fund contributions will bolster the future earnings of IBM and those of a number of other major companies that have announced plans to top up pension plans that face future deficits.

The size of this boost to future earnings depends on how much companies contribute to their underfunded pension plans, multiplied by the rate of returns they project. On the former matter, 21 major corporations will contribute a total of \$32 billion in the next few years to their pension plans, according to a recent survey by Pensions & Investments, an industry periodical. Of that, \$7.6 billion will be added by yearend, the publication reported (prior to IBM's announcement).

Most of the impact will be felt at older, big companies because that's where most traditional defined-benefit pension plans still reside. It's less pronounced at newer and smaller firms, which tend to have defined-contribution plans such as 401(k)s.

The [table](#) here lists some companies that have announced planned contributions, along with their assumed rates of return. The pension plan may not actually earn the assumed rate in a particular year, but accounting rules let companies smooth out volatile year-to-year results.

Whether those rates of return will actually be realized over the long haul, however, is another question. While most of the companies listed here continue to assume that their plans will earn the 9%-10% a year that equities historically have returned, others are being more conservative. IBM, for instance, has cut its assumed rate by a percentage point, to 8.5%. Other companies are likely to have to lower their return assumptions, as well.

Remember, too, that pension-fund portfolios also include a significant portion in bonds. With the benchmark 10-year Treasury yielding just over 4%, the fixed-income portion of a typical retirement plan will return significantly less than the 9%-plus assumed rate for the entire portfolio. Thus, the assumption for the equity portion has to be even more optimistic to meet that 9%-10% bogey for the entire pension portfolio.

If -- or when -- pension plans lower their assumed rates of return, the boost to earnings from pension contributions also will be decreased. And if Mr. Market continues to fail to meet those return assumptions, the size of the funding gap will remain large.

Of course, things actually could go right. As noted, stocks' recent rally has allowed IBM to trim its total planned pension-fund contribution to \$3 billion from \$4.5 billion. [Ford Motor](#) also said the rally had pared its pension deficit by \$1 billion.

Companies that face crucial balance-sheet and cash-flow problems, such as the airlines, no doubt would also like to be able to reduce their pension-fund contributions. They need to husband precious cash needed to keep their current operations going -- regardless of any impact on reported earnings.

So how big will be the impact of pension-fund contributions on earnings? Chuck Hill, director of research at Thomson First Call, estimates that they will add 29 cents a share to the average 2003 analysts' estimate of \$55.39 for the companies in the Standard & Poor's 500.

"It is something we have to pay attention to," he says. "If you look at one of those companies with a big pension contribution, you better dig into the footnotes to see what their actual earnings are."

"Unfortunately, by looking at the headline number, you can't tell."

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