

TODAY IN
BARRON'S ONLINE

THIS WEEK'S
BARRON'S

COMPANY STORIES

MARKET
COMMENTARY

ELECTRONIC
INVESTING

Q & A /
MUTUAL FUNDS

MARKET LAB

YOUR PORTFOLIO

SEARCH / ARCHIVES

HELP

CONTACT US

STOCK QUOTES

Select exchange:

Enter symbols:

[Symbol lookup](#)

PRINT
SUBSCRIPTIONS



FRONT PAGE

MONEY & INVESTING

MARKETS

DATA CENTER

BRIEFING BOOKS

Click for more tips.
www.understandingprivacy.org

This privacy tip courtesy of The Privacy Leadership Initiative



BARRON'S

BARRON'S

OnlineSM

JULY 9, 2001

Red-Handed?

Analysts worry that pension gains smack of cookie-jar accounting

By ROBIN GOLDWYN BLUMENTHAL

Some investors view [Qwest Communications](#) as the perfect marriage of New Economy and Old Economy. Having acquired US West, the Baby Bell, in 2000, Qwest, which is building a state-of-the-art broadband Internet-based communications system, has the benefit of a steady flow of income to subsidize its losses.

A chunk of that so-called income, however, derives from the company's treatment of its pension accounting, and some analysts have raised questions about whether it can be sustained down the road. According to a recent report by Morgan Stanley that examined a number of accounting issues, \$253 million, or 15 cents, of the firm's \$995 million, or 59 cents a share, in net income, resulted from changes in the company's pension accounting. It's worth noting that the income Qwest derived from its overfunded pension plan did not deliver any actual cash to the company to fund operations. But investors would be hard put to discover that from the quarterly financial statements.

Qwest's accounting, it should be stressed, is well within generally accepted accounting principles and is perfectly legal. Indeed, companies are actually required by the Financial Accounting Standards Board to book pension income (or expense) once a year. But investors in Qwest and 157 other companies in the Standard & Poor's 500 whose earnings got a boost from pension income last year should wonder about whether those earnings boosts can be sustained year after year. "The problem is they [Qwest] went from the old US West, which had the most conservative assumptions, to being at the top end of assumptions," says

Trevor Harris, who heads Morgan Stanley's valuation and accounting research group and is an author of the report. Those changes included raising the expected rate of return on plan assets to 9.4% from 8.8%, even though, the analysts say, the actual return on the plan's assets was negative last year.

If the assumptions are too aggressive, Harris says, it may be difficult for Qwest to maintain its level of earnings growth, which is a key way investors value stocks. "Qwest could be totally justified in changing these assumptions, but then you have to look at the sustainability, and next year's growth, and you have to question whether they'll be able to continue it," Harris says.

Qwest hotly disputed the findings of the Morgan Stanley report, arguing in a press release and a subsequent conference call that the accounting analysis is "incorrect and its conclusions about Qwest's business and prospects are wrong." The company added that "nothing they say in their report has anything to do with our prospects for future performance," and that "nothing they say, except by unsupportable innuendo, casts any doubt on any of our accounting practices."

Robin Szeliga, Qwest's chief financial officer, adds in an interview with Barron's that the company "earned a return over a long period of time well in excess of 9.4%, and using 9.4% brings our actual and expected returns closer together."

We have no reason to doubt that. But the Qwest situation raises the bigger question of the reliability of reported earnings in general. Even Szeliga, who believes all the assumptions Qwest made are reasonable, allows that the whole area of pension accounting, "when looked at under the spotlight, raises eyebrows."

Indeed, pension accounting is beginning to raise a lot of eyebrows on Wall Street. For example, a June report from Credit Suisse First Boston entitled "A Pension Accounting Primer" noted that pension income contributed about 12% to the pretax profits of the 30% of companies in the S&P 500 that report pension income. And because the outlook for corporate earnings looks to be grimmer this year than last, pension income may become a more significant, though not necessarily more visible, component of the bottom line.

It works like this: The great bull market of the 1990s helped to ratchet the value of pension plans beyond their future obligations. Additionally, when companies increase their assumptions on future returns, the complex formula used in pension accounting boosts the overfunded status of their pension pools even further. So companies have increasingly been able to -- indeed have been required by accounting conventions to -- slide dollars out of their pension plans, on paper at least, and into their income statements.

Jack Ciesielski, publisher of the Analyst's Accounting Observer, notes that "the easiest and most direct way for a company to boost the current year's reported earnings is to raise the expected rate of return on pension assets." If you do that, during the year, "it will go right to the operating line," he says. Other changes that can influence earnings are changing the discount rate, which establishes the current cost of future obligations, and changing the health-care-cost trend rate. The changes often boost reported earnings, but never does any real cash flow into the companies' coffers.

Interestingly, Ciesielski notes that as recently as 1997, defined-benefit pension plans were a liability for the 81 companies in the S&P 100 that have plans, not an asset to be drawn upon to increase reported earnings. "From a nearly \$5 billion in cost in 1997, pension plans now chip in nearly \$7 billion of cost reduction in 2000."

Ciesielski dedicated the entire May issue of his publication to examining the way pensions affect earnings of the S&P 100 companies. The subject, he says, is often overlooked because pension income is reported only once a year. What's more, accounting conventions require that pension results be spread over different parts of the financials, which means investors have to hunt through footnotes in annual reports to discover their full effect.



Tom Bloom for Barron's

Even if pension income isn't the most significant driver of earnings, Ciesielski notes, "the fact that it's so big should get people to look for the effect they're having on earnings." He adds, "If you've got pension income in there, it makes earnings look better than they really are."

Ciesielski and others argue that the pension reporting should be changed, to make its effect on earnings more transparent, or even remove it from operating earnings altogether.

A tricky proposition

While overfunded pension plans can make a company's earnings look good, it is very difficult for a company to actually tap into the funds and use them for operations without paying big tax penalties. "When you see pension income, it doesn't hold the promise of having the cash go back to the company and the shareholders," Ciesielski says. "But if companies can't tap pension funds for general corporate purposes, executives whose compensation is tied to earnings performance can benefit from overfunded plans' contribution to the bottom line."

Qwest may be a case in point. This year, a US West retiree group proposed exempting any surplus from Qwest's pension fund from income reports, which are used to calculate executives' bonuses. Qwest Chief Executive Joseph Nacchio last year received \$2.8 million in salary and bonuses, realized \$93.4 million from options exercised last year and was paid \$1.1 million in shares promised to him before Qwest went public in 1997. Szeliga, Qwest's CFO, noted that the proposal, which the company opposed, was voted down. She explains that the company uses generally accepted accounting principles in providing information to the compensation committee, which then determines compensation. The retiree group's "suggestion was to deviate from GAAP, and we think that wasn't appropriate."

Examining the effect of pension income on earnings is a tricky proposition. For example, last year [Boeing](#) booked \$428 million in pretax non-cash earnings from its overfunded pension plan. But a Boeing spokeswoman notes that those gains simply offset the non-cash charges that Boeing booked for retiree medical health benefits and other expenses. "We're making our earnings based on operating income," she says, and notes the company has had significant growth in a share-based incentive plan for employees.

Jane Adams, an accounting analyst at CSFB and the author of "A Pension Accounting Primer," identifies [Verizon Communications](#) and [General Electric](#) as the two companies whose plans were the most overfunded in 2000 ([see table](#)), but [Ciesielski](#) points out that because of the size of their workforces, they also may have the biggest pension obligations. He proposes that investors focus on the number of years a company could fund its pension obligations if they were frozen at yearend 2000 ([see table](#)). This analysis of burn rates for overfunded pension plans turns up some interesting observations. ("While [General Electric](#) is the most frequently criticized firm for having a pension surplus, it ranks fifth" in the burn-rate scenario pictured in the accompanying table. "Even though the biggest overfunding exists at [Verizon](#), their equally huge benefits-spending drives their burn rate down so much that they rank only the 13th best of the bunch," [Ciesielski](#) writes.)

At the top of the burn-rate list is utility company [Southern Co.](#), with an enormous 21 years to garner earnings benefits on its pension surplus at its current rate. Comptroller Dean Hudson says the plan is comparable with other companies, especially utilities, and notes that Southern hasn't contributed funds to its plan in a long time. He also notes that the company has made benefit improvements to the tune of \$28 million a year. "Every now and then we give retirees an inflation pay raise," he says. But with such a huge pool of non-cash earnings to draw upon for years to come, investors may want to examine Southern's earnings closely to determine how well the company is actually doing at producing cash profits.

Trevor Harris cautions investors to be mindful of pension accounting's effect on reported earnings, both in assigning a value to a company's stock and especially when comparing its valuation with companies that don't have defined-benefit plans that can affect earnings. Defining the issue succinctly, he asks, "If you look at a company and half of its operating income is coming from gains on net pension assets and another company has the same level of operating income, all from operations, which one would you pay more for?"

E-mail comments to editors@barrons.com



Career Journal.com

[click here](#)

[Return to top of page](#) | [Format for printing](#)

Copyright © 2002 Dow Jones & Company, Inc. All Rights Reserved.

[Copyright and reprint information.](#)