Top Financial News

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Pension Accounting Turns $31 Billion of Losses Into Earnings

By David Evans

New York, March 21 (Bloomberg) -- Nine of the largest U.S. companies obscured $30.61 billion in pension-fund losses in 2002 because of an accounting rule, boosting corporate earnings and prompting calls for a change in regulations.

Verizon Communications Inc., Lockheed Martin Corp., International Business Machine Corp. and six other companies each lost more than $1 billion in pension-fund investments last year, according to footnotes in their annual reports.

Verizon, which lost $4.68 billion, reported a $2.5 billion pension gain. That accounted for 40 percent of its 2002 pretax earnings. U.S. accounting rules call for companies to include estimated pension gains, rather than actual returns, in their income statements. As a result of the rule called FAS 87, the nine companies legally transformed $30.61 billion of pension losses into pretax earnings of $7.9 billion, annual reports show.

``I don't like the FAS 87 model,'' said Robert Herz, chairman of the Financial Accounting Standards Board, which wrote FAS 87 in 1985. ``I

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believe you're better off showing what actually happened.''

As a first step pension disclosure to investors should be improved, he said. FASB decided last week to develop a new pension- accounting proposal, with a draft expected by year-end.

None of the nine companies with billion-dollar pension losses disclosed the amount of losses in the management discussion and analysis section of their annual reports to the Securities and Exchange Commission, most of which were filed in the last three weeks. The losses were included in footnotes to financial statements in those reports.

More Disclosure

Last month, SEC officials said companies aren't providing investors with clear disclosure about pension accounting. Carol Stacey, chief accountant of the SEC's division of corporation finance, said in an interview that there was a ``general lack of informative transparent disclosure'' in more than 500 annual reports for 2001 reviewed with her staff.

Alan Beller, director of the SEC's division of corporation finance, said in an interview last month that actual pension returns should be included when companies discuss pension accounting and pension fund performance.

``The actual rate of return is something that should be an element of that disclosure,'' Beller said.

The FAS 87 rule requires companies to use estimated pension investment gains, rather than actual gains or losses, to ``smooth'' away stock-market volatility, according to its primary author, Tim Lucas.

FASB Chairman Herz said in an interview he discussed the need to improve pension-accounting disclosures last Friday in a meeting with the SEC's Stacey.

Estimating Returns

The FAS 87 rule requires companies to estimate long-term stock-market performance. The nine companies computed their 2002 pension earnings based on average expected rates of return of 9.2 percent.

Their pension funds actually suffered losses averaging 9.3 percent in 2002 and 7.97 percent in 2001, and have reduced their 2003 expected returns to an average of 8.58 percent.

``I certainly don't have those kind of expectations for my portfolio,'' said Herz, an accountant who became FASB chairman last summer after retiring as a partner at PricewaterhouseCoopers LLP.

Also skeptical is Ethan Kra, chief actuary of the U.S. retirement practice at Marsh & McLennan Cos.' Mercer Human Resources Consulting, the world's largest actuarial firm.

``Some companies think their money managers will outperform the market,'' Kra said. ``I believe the most likely result is generally between 6.5 and 7.5 percent for the next ten or twenty years.''

Bull-Market Distortions

Lucas, project manager of the FASB team that wrote FAS 87 18 years ago, says the board reasoned that since studies show that stocks appreciate over the long term, and can be volatile in the short term, it made sense to use a smoothing technique.

The FAS 87 rule distorts earnings during bull markets, too, company filings show. In 1999, pension earnings for the nine companies exceeded expected rates of return. Their pension funds actually gained $55.19 billion, while pretax earnings were only boosted by $5.34 billion.

Lucas said that's how the companies managed to report pension earnings in 2002 as their pension funds actually lost money. ``Gains that happened during prior years were saved up by the smoothing device of FAS 87,'' he said.

Verizon, the largest U.S. local telephone company, got the biggest boost of the nine companies identified by Bloomberg News. The company relied on its pension fund for 40 percent of its 2002 pretax earnings of $6.2 billion.

Loss in Footnote

The company reported $2.5 billion gain from the pension fund, under FAS 87, as the fund actually lost $4.68 billion on its investments. The expected rate of return was positive 9.25 percent, while the actual return was a negative 9.63 percent.

The management discussion and analysis section of Verizon's annual report filed on March 14 didn't mention the pension plan's actual loss, which was found in a footnote.

``Investors aren't investing in Verizon's pension plan, they're investing in Verizon,'' said company spokesman Robert Varettoni. ``We follow all SEC rules. We think we're providing all the necessary disclosure.''

Lockheed Martin, the largest U.S. defense contractor, added $160 million to 2002 earnings with estimated pension earnings, as its pension fund actually lost $1.4 billion. The company used an expected rate of return for the fund of 9.5 percent; the fund actually lost 6.9 percent. Lockheed Martin didn't mention the pension loss in its discussion section of its annual report.

``The $160 million that is listed as income, according to FASB, is just that, a list of numbers on paper and not cash income, and no indication of the fund's performance on the market,'' said Lockheed spokeswoman Meghan Mariman.

SBC Communications

SBC Communications, the second-largest U.S. local telephone company, boosted pretax earnings in 2002 with $1.14 billion of estimated pension earnings, based on an expected rate of return of 9.5 percent. The pension fund actually lost $3.4 billion, or 10.5 percent. The loss wasn't mentioned in the annual report's management discussion and analysis.

``We feel like it's good disclosure,'' said SBC spokesman Russell Johnson. He said the management discussion is 12 pages more than in the 2001 annual report. ``It's a lot more than it was last year.''

IBM, the world's largest provider of computer services, boosted pretax earnings by $520 million from estimated returns, as its pension fund actually lost $6.94 billion. Its expected rate of return was 9.5 percent, and its actual return was a loss of 11.35 percent. The loss wasn't specified in the annual report's management discussion and analysis, which directs readers to footnote W for more information about retirement plans.

``We point people to the footnote section where they can get detailed information,'' said IBM spokesman Joe Stunkard.

Here is a chart of the nine companies, their actual pension fund losses for 2002, as described in the pension footnotes of their annual reports, and the pretax gains reported from pension- fund investments, as filed with the SEC:

	2002 Pension Earnings:	
	Actual	Earnings Boost
IBM	-$6.94 bln	+$520 mln
General Electric Co.	-$5.25 bln	+$1.56 bln
Verizon Communications Inc.	-$4.68 bln	+$2.50 bln
SBC Communications Inc.	-$3.40 bln	+$1.14 bln
Boeing Co.	-$3.27 bln	+$400 mln
Lucent Technologies Inc.	-$2.47 bln	+$580 mln
Lockheed Martin Corp.	-$1.40 bln	+$160 mln
BellSouth Corp.	-$1.28 bln	+$830 mln
DuPont Co.	-$1.92 bln	+$220 mln
TOTAL	-$30.61 bln	+$7.9 bln

If actual pension returns had been counted in financial statements, aggregate earnings for the S&P 500 would have been 69 percent lower than the companies reported for 2001, or $68.7 billion rather than $219 billion, Credit Suisse First Boston Corp. found in a research study on pension accounting published in September.

Stock-market declines in the past two years have led to more than $200 billion in pension-fund losses for S&P 500 companies, according to the CSFB study.