S&P Sheds Light On Accounting For Pension Costs

By Cassell Bryan-Low

IF BROWN IS THE new black of fashion, pension funds have eclipsed stock-option expensing as the new hot-button issue of accounting.

While momentum has grown in support of expensing stock options since the beginning of the year, pension-related matters have come on strong of late as a subject to be dealt with, just how big an issue is something that numbers are being publicly released today by Standard & Poor’s shed light on.

On a net-income basis, the big-company S&P 500-stock index earned $28.74 a share for the 12 months ended June 30. But, after adjusting to account for items including both the expensing of stock options, the figure drops to $18.48 a share, which S&P calls "core earnings." Of the difference, pension-fund costs outpace stock-option costs, $6.54 a share versus $5.21, while some positive items kick in to offset some of the collective bad news.

"If 2002 was the year of options, the year 2003 will be that of pension-fund accounting," says Kenneth Shea, head of global equity research at S&P, a unit of McGraw-Hill Cos.

Consider Anheuser-Busch Cos., the world's largest brewer. Based on S&P's methodology for calculating "core earnings," the St. Louis company would have reported $1.84 a share for the 12 months ended June 30. S&P notes that on a net-income basis it reported $2.05 a share. Of the difference between the two numbers, eight cents comes from the expensing of stock options, while nearly double that—14 cents—is attributable to pension-fund costs. A spokesman for Anheuser wasn't immediately able to comment, noting that the company was busy releasing third-quarter earnings yesterday.

In its calculation of pension costs, S&P uses actual returns generated by pension funds, as opposed to expected returns as allowed under Generally Accepted Accounting Principles. For most companies, S&P's methodology increases their pension costs for this year, because many companies assume, as permitted under GAAP, that their pension plans will return 9% or 10%, while in reality this year's tough stock market has resulted in widespread negative investment returns. Under GAAP, the expected rate of return on the plans...
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offsists some, or all, of the annual costs of offering pension benefits, including the accrual of additional benefits by a workforce during the year.

S&P opted to use an actual investment return, rather than the expected one, to give a better snapshot of the current cost of pension benefits, Mr. Shea says. “Investors should understand that companies with large, defined pension obligations may not be as financially sound as investors would think if they just looked at the income statement alone,” he says. In 2001, all but two of the S&P 500 companies with traditional pension plans had investment losses in their pension funds, he says.

S&P’s definition of “core earnings” is an effort to introduce consistency in corporate financial reporting. The Financial Accounting Standards Board, a nonprofit private-sector body, sets standards for U.S. companies to use in calculating net income for purposes of regulatory filings. But companies aren’t precluded from publicizing other earnings benchmarks. In May, as investors’ heads were reeling from the proliferation of company-designed benchmarks that invariably presented the rosier picture possible, S&P unveiled an initial “core earnings” definition, with a revised version accompanying the release of the figures today.

Besides the inclusion of an actual rate of pension-fund investment return and the expensing of stock options, S&P’s core earnings incorporate restructuring and other charges that relate to continuing business activities; such charges typically are excluded from companies’ self-designed operating-earnings benchmarks. While a growing number of companies have announced their intent to expense stock options, few have already begun to do so; GAAP doesn’t require such expensing in the calculation of net income.

The move by S&P provides further ammunition for those who think the market is too expensive. Using the relatively rosy operating-earnings figures that companies individually design, the S&P 500 is trading at a price of about 24 times earnings for the 12 months through June 30, while on a net-income basis, it is trading at about 37 times earnings. But using S&P’s definition of core earnings—with pension-plan costs, stock-options expensing and restructuring charges thrown in—the ratio grows to 54, S&P says.

Still, David Blitzer, chief investment strategist for S&P, notes such ratios only become meaningful in comparison with historical figures based on the same methodology. He adds that some costs don’t affect all companies equally, noting that stock-option expensing has the biggest impact on the technology sector while pension costs are heaviest for old-line industrial and telecommunications companies.

Robert Willens, an accounting analyst at Lehman Brothers Inc., is among those who applaud S&P’s efforts. “People have absolutely no confidence at all in the pension numbers being reported because so much of it is fictitious,” he says.

Mr. Willens adds that while earlier this year institutional investors were calling him with questions about stock options and off-balance-sheet accounting, “now it’s 100% pensions.” Ironically, he notes, pension-fund accounting isn’t on the agenda of the standard setters at FASB.

“The idea of getting a standard you can compare across companies is very important for investors,” says Brett Gallagher, head of U.S. equities at Julius Baer Investment Management in New York, which has about $3.9 billion in assets under management. “Without it, you are flying blind. When you leave the person being graded in charge of what the numbers are going to look like, you are looking at potential abuse.”

Critics of S&P’s methodology have dubbed it just another “pro forma,” or “as if,” measure of profitability. S&P acknowledges that no valuation method is without its drawbacks. Indeed, disagreement over what should be treated as a pension cost delayed release of the definition until today. Still, says Mr. Shea, while there can be differing opinions on exactly what to include in any definition, the usefulness lies in providing a standard that aims to provide investors with more transparency.

As a result of feedback, S&P has tweaked its definition since unveiling the first version in May. Among other things, some aspects of the treatment of pension-fund cost were changed. The new definition includes merger- and acquisition-related expenses as well as unrealized gains and losses from hedging activities, which under the earlier version would have been excluded.