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Pension Folly: How Losses Become Profits

In the land of executive compensation, there is nothing like being paid for profits that you can be sure will be counted, even if they do not exist. Why take chances with real earnings?

Last year, [Verizon Communications](#) reported net income of \$389 million after taking losses for a variety of things, among them investments in [Metromedia Fiber Network](#), a company whose shares have plunged from a peak of more than \$50 to less than 5 cents. Top officers' bonuses were reduced but not eliminated.

Things could have been even worse for Verizon and its bosses. The net would have been negative, save for \$1.8 billion in income the company was able to report from its pension plans.

The only trouble is that Verizon's pension plan was really swimming in red ink. Dig through the company's annual report, and you will find that the pension funds had a negative return on investment last year, dropping \$3.1 billion. And that is before considering the costs of pension benefits.

So how did billions in losses turn into nearly \$2 billion in profits? Verizon assumed that its pension plans would earn profits of 9.25 percent last year, and it reported income as if that assumption were true, something it was able to do under the current ridiculous accounting rules. Its earnings would have been even better had it assumed a 9.5 percent return, as [General Electric](#) did, or a 10 percent return, as [I.B.M.](#) did. In fact, both those companies lost money in their pension plans last year, as did most big companies.

A study by Milliman USA, a benefits consulting firm, found that in 2001 the reported results of 50 large companies included \$54.4 billion of profits from pension fund investments. In fact, the pension funds lost \$35.8 billion from investments last year.

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The losses are buried in annual report disclosures that few can understand. Harvey L. Pitt, the chairman of the Securities and Exchange Commission, has promised to make annual reports more understandable. This would be a good place to start. Even better would be a new accounting rule requiring actual results to be used.

The theory of the current rule is that over time, all this will balance out — that pension income will be understated in the good years, as it was for most companies in the late 1990's, and overstated in the bad ones. But what has resulted is highly misleading.

Shareholders have started to become upset, particularly because many companies include the phantom income in determining whether executives qualify for performance bonuses. At Verizon's annual meeting this week, a proposal to bar the consideration of pension income from bonus calculations was supported by 43 percent of the shares.

Fred Salerno, Verizon's chief financial officer, says there is no way to know how much the pension income contributed to the bonuses because a different formula would have been used if it had been excluded. He notes that the company knew the approximate pension income it would report last year when it set the formula.

Executives might do better in the future if they stopped considering reported pension income when bonuses are calculated, simply because pension income is headed lower. The complicated pension rules will force companies to report poorer results this year because last year's reality was so bad. And John Ehrhardt, a principal at Milliman, says that auditors in the post- [Enron](#) era may force companies to reduce their optimistic assumptions.

Investors would do well to study the pension disclosures in this year's crop of annual reports. They show that many plans that seemed to be overfinanced a couple of years ago no longer are. Pensions are going to go back to costing companies money — both in reality and, soon, even in their published financial statements.

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