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Fool on the Hill: Know Your Earnings

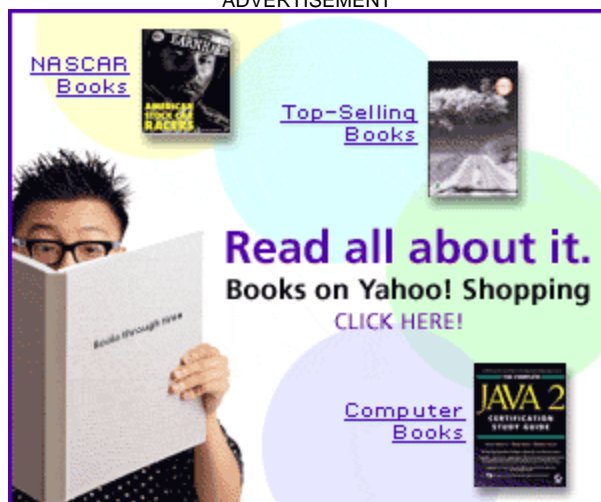
By Mike Trigg

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You might recall how, in the movie *Wall Street*, Gordon Gekko tries to buy BlueStar Airlines. That leveraged buyout, which was ultimately thwarted by Bud Fox, was driven by Gekko's attraction to the airline's \$80 million overfunded pension plan, which Mr. "Greed Is Good" would have pocketed. The fictitious scenario is an example of what can and has happened to corporate pension plans: The bull markets of the '80s and '90s increased pension funds beyond their future obligations. **General Electric** (NYSE: [GE](#) - [news](#)), for instance, has pension assets of \$50 billion, more than double its liabilities.

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In his book *Financial Shenanigans*, Howard Schilit defines financial shenanigans as "actions or omissions intended to hide or distort the real financial performance or financial condition of an entity." Investors who follow the market closely have come to understand that shenanigans are everywhere: Companies sometimes use aggressive revenue recognition policies, for example, to report sales before they occur.

One shenanigan companies have been employing for years deals with pension income. For businesses, dipping into pension fund income to boost earnings has become as commonplace as workplace gossip at the water cooler. Jack Ciesielski, publisher of the "Analyst's Accounting Observer," recently released a

report that said of the 100 largest companies in the S&P 500, earnings from pension funds increased operating income 6% last year, versus a 4% increase in the prior year.

Sadly, the effects pension income has on earnings are buried in the footnotes of company reports. The Motley Fool has written at length about the importance of investors familiarizing themselves with 10-Q and 10-K filings to attain a complete view of a company's business. Unfortunately, the complexity and difficulty often associated with such exercises discourages many investors from doing so. In the end, however, it's questionable accounting practices like this one that makes reading reports so valuable.

The increased value of pension funds -- which are invested in various securities -- has left companies with excess funds to play with. Companies have primarily used three ways to boost earnings with pension accounting:

- ⚡ Raising the expected rate of return on plan assets. The better plan assets are expected to perform, the less the company has to fund the plan out of its own revenue;
- ⚡ Raising the discount rate of future obligations. The higher the discount rate, the lower future obligations -- what must be paid to employees upon retirement -- become; and
- ⚡ Lowering the rate of compensation (i.e. pay-out benefits) increases. By lowering this rate, the company decreases the amount it must pay employees.

Standard accounting rules permit management to change the underlying assumptions behind these figures -- something a company would only do if its pension fund were overfunded -- which in turn allows them to manipulate income. (When pension plans are underfunded, the companies can see significant added expense.)

Sound confusing? Even accounting experts Donald Kieso and Kerry Weygandt describe pension fund accounting as "not perfectly logical, totally complete, or conceptually sound" in their textbook *Intermediate Accounting*.

Still, the list of companies that have benefited from pension income contains some of our most respected and well-established businesses. The world's largest computer company, **IBM** (NYSE: [IBM - news](#)), realized an \$820 million gain to its after-tax bottom-line because of pension gains in 2000, according a *Forbes* article (free membership required) earlier this year. That 63% improvement in pension profits in part was accomplished because the company increased the expected return on its pension fund from 9.5% to 10%.

Telecommunications giant **Qwest** (NYSE: [Q - news](#)) has been chugging the pension fund Kool-Aid as well. Morgan Stanley reported last month that changes in pension fund accounting contributed \$253 million, about 25% of its net income, last year. Qwest did this by raising its expected rate of return from 8.8% to 9.4%, while also increasing its discount rate from 6.75% to 8%, lowering the present value of future obligations.

Not surprisingly, both IBM and Qwest have provided well-planned and technically correct explanations for their actions. Both companies' accounting maneuvers are legal and comply with generally accepted accounting principles (GAAP). Plus, as an IBM spokesperson responded in the *Forbes* article, earnings could be hurt in future years if the expected return decreases below the current rate expectation.

Why should any of this matter? After all, if every company is drinking the pension Kool-Aid, shouldn't they be rewarded for amassing overflowing pensions? Absolutely not!

Investors care about earnings because that's what should ultimately benefit them, either in the form of stock buybacks, dividends, or additional investment in a company's business. Earnings that stem from pension assets, however, won't ever benefit investors because the Employee Retirement Income Security Act prohibits companies from using pension assets for any purpose other than benefiting plan participants. Thus, while excess pension income might make its way to the income statement, you won't see any of it.

In addition to the pension fund participants, some of the biggest benefactors of pension income can be company executives. Qwest's CEO amassed more than \$90 million in salary, bonuses, and exercised

options last year, most of which was related to the company's performance -- measured in part by earnings. Hence, I wasn't shocked to learn, according to a *Barron's* article, that a retiree group from U.S. West, which Qwest acquired last year, proposed to exclude the effects of pension income on earnings. That proposal was ultimately voted down as Qwest hid behind GAAP rules.

Qwest and IBM aren't the only ones benefiting from pension gains. **Unisys** (NYSE: [UIS](#) - [news](#)), **Lucent** (NYSE: [LU](#) - [news](#)), **Verizon** (NYSE: [VZ](#) - [news](#)), and **Allegheny Technologies** (NYSE: [ATI](#) - [news](#)) were some of the biggest gainers in pension income last year, according to Ciesielski's report. As I said earlier, however, the difficulties in assessing whether a company has benefited from pension income are somewhat prohibitive. The good news is that the SEC is considering a move that will require companies to be more explicit in reporting how pension income impacts earnings.

This shenanigan is so egregious Warren Buffett decried it at the press conference following **Berkshire Hathaway's** (NYSE: [BRK.A](#) - [news](#)) annual meeting this year. Having said that, Buffet would probably also agree that an overfunded pension is a strength investors should consider when assessing a company's overall financial standing. Companies could, for example, retain employees by increasing compensation upon retirement. Bloated income from pension assets, however, should lead you to question the quality of a company's earnings.

In the meantime, one way to avoid this shenanigan (and most others) is to concentrate on cash flow, rather than net income, when analyzing companies. (We have written numerous articles about the importance of cash flow, which accountants can't tweak as easily as earnings.) The income derived from pension gains has little effect on cash.

Importantly, this problem only affects companies that participate in defined benefit (or traditional pension) plans: Many large, established companies still have these, though nowadays defined contribution plans -- 401(k)s, for example -- are more common.

Mike Trigg spends his days offering readers what Gordon Gekko called "the most valuable commodity": information. Mike's holdings can be viewed in his personal profile. The Motley Fool is investors writing for investors.

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