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WHY PENSION PLAN ACCOUNTING MATTERS, PART I

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Talking Points

1. How a company treats the complex issue of its pension plan accounting can affect its very valuation.
2. So-called "old economy" businesses are most affected, because they're most likely to have defined benefit plans.
3. Make sure that a company's assumptions regarding the plan are appropriate, and that earnings aren't being either unduly elevated or suppressed by those assumptions.

In these very uncommon market times, we are hearing quite a bit about pension plan accounting and how corporations with large "defined benefit" pension plans are fudging some of the pension plan's assumptions to make earnings look a little better. However, although there's quite a bit of chatter in the popular media, there hasn't been an intelligent discussion of the topic, because of its complexity, and because it would hold the average TV viewer's attention for about five to 10 seconds.

But there's reason to focus: The analysis of pension plan details has implications for both the balance sheet and the income statement, which obviously affect the company's valuation.

In the first part of this series I'll provide an overview of the topic. In the second part, coming next week, I'll look at the mechanics and the details.

There are two types of corporate pension plans (in general):

Defined contribution plan: This is more commonly known as the 401(k). This type of plan transfers the entire risk of the retirement funding to the employee, and it is funded entirely by the employee, unless the employer has a matching contribution, which is not a contractual obligation of the company.

Defined benefit plan: This is a pension plan for which the company (very key point) bears the majority of the funding requirements for the employee retirement funding, the benefits of which are typically based on some level of years of service and official rank within the company. The key consideration for the analyst or portfolio manager is that future obligations must be funded from either the invested plan assets or current corporate cash flows, and the corporation bears the risk to fund these contractual obligations. Also, the company must recognize the pension expense as earned under Financial Accounting Standards Board issuance 87, rather than simply when paid out as a benefit, and must accrue for the future liability.

To further complicate the matter, the board's FAS 106 rule requires

companies to use accrual accounting to measure costs and liabilities for other post-retirement employee benefits. Those liabilities are very similar to pensions both in size and calculation, and corporations in the 1980s and early 1990s used a "pay as you go" accounting methodology (recognizing the expense when paid, rather than accruing for the benefit when earned).

Not all companies have defined benefit plans or offer substantial post-retirement health care benefits, therefore these companies that don't offer or haven't offered a defined benefit plan won't incur these often-substantial liabilities.

Sectors or corporations that warrant a review of the annual report for pension plan details have a number of the following themes in common:
* They tend to be older, more mature industries that are in the later stages of their life cycle. Examples include the steel industry, the automotive industry, the airline industry, the capital goods sector, etc. These industries existed long before the enabling legislation of the 401(k) plan in the late 1970s, which effectively transferred the risk of retirement funding from the corporation to the individual.

* These industries are often heavily unionized, with a substantial part of the labor force engaged under collective bargaining agreements.

* The workforce is older, with substantial work time accumulated, and thus a substantial liability has been accruing for some time. This is very relevant to health care retirement benefit liabilities.

If we look at a cross section of the **S&P 500** by market capitalization, outside of technology, financial services and retail -- the sectors that came of age in the 1980s and 1990s and thus have the majority of their employees covered under the 401(k) or defined contribution plan -- the above characteristics encompass the rest of the S&P 500, or "old economy" businesses.

To summarize thus far, if you are looking at the annual report of **Cisco** (CSCO:Nasdaq) or **Microsoft** (MSFT:Nasdaq) or **Starbucks** (SBUX:Nasdaq) or some other growth company that is fairly young, the corporation has probably decided to transfer the retirement funding risk to the employee via the 401(k), or what is officially called the defined contribution plan, and thus has not enacted a defined benefit plan which the company would have an obligation to fund.

If, however, you are looking at the annual report of an "old economy," mature business which may or may not have an older workforce, and which is probably unionized in some form or fashion, then you had better be sure and examine the pension plan details to see if the company's assumptions regarding the plan are appropriate, and whether earnings are being either unduly elevated or suppressed by the pension plan assumptions and details therein, given the often substantial size of the liability.

This is *not* an iron-clad rule but more a rule of thumb. The older the company and the more mature the business, the greater the likelihood of a defined benefit plan with a meaningful liability that may require current or future funding. A young company with a workforce that averages 25 years old,

such as a **Whole Foods** (WFMI:Nasdaq), for example, may have a defined benefit plan for its employees, but the future liability is so far away, it isn't yet meaningful from a funding or "projected benefit obligation," i.e., future liability, perspective.

Disclosure

Gilmartin is long Cisco, Microsoft, Starbucks and Whole Foods.