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Pension Inquiry Shines Spotlight On Assumptions

Small Changes in Calculations At Companies Have a Big Effect On Retiree Liability -- and Profit

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Labor unions and the government's Pension Benefit Guaranty Corp. want to make sure big companies' pension funds are healthy enough to pay promised benefits to current and future retirees. The Securities and Exchange Commission, on the other hand, is grappling with another question: Did the companies tweak key financial assumptions of these plans to make the companies themselves look more flush?

The SEC, which refers internally to any such maneuvers as "reverse engineering," is probing whether companies had an eye on their shareholders, not their retirees, when they changed some financial assumptions in recent years, according to people familiar with the matter.

Such assumptions are used, say, in calculating the size of a plan's future pension obligations. The SEC's interest in the pension plans has been known for months, and details about the probe, including the focus on the financial assumptions, continue to surface.

A look at some of the assumptions involved in calculating the funding status of the plans at General Motors Corp., one of the companies under review, shows how small changes -- such as a quarter-point increase or decrease in the interest rate used to calculate the total liability -- can change the size of that obligation by billions of dollars. GM estimates that its plans, with about $100 billion in assets, were slightly overfunded at the end of 2004.

GM, which has said it is cooperating with the SEC's probe, declined to comment for this story. Boeing Co., Delphi Corp., Ford Motor Co., Navistar International Corp. and Northwest Airlines also have disclosed SEC inquiries about their pension plans, with some saying their accounting was proper. The agency hasn't accused any company of wrongdoing.

The SEC also is looking at pension-accounting issues that don't involve assumptions but can help burnish a firm's financial statements, the people said. At the same time, the Financial Accounting Standards Board is scheduled to vote tomorrow on whether to take another look at pension-accounting rules. The FASB's existing rules have been criticized as allowing companies to distort their financial performance, and the board may consider stricter standards.

Many assumptions at issue are disclosed in footnotes of the companies' financial statements. On their face, a company's choices are difficult for outsiders to challenge. While an interest rate may look high or low, a company always could argue it made a good-faith estimate. But the SEC is using its subpoena power to dig into the thought processes, to determine if the estimates were made in good faith -- or were results-driven.

That is, did the companies come up with the desired result first, and then figure out which assumptions would get them there?

"The key to whether or not any of these companies will have a problem with the SEC will depend on how they support their pension assumptions," said David Zion, an analyst who specializes in accounting and taxation for Credit Suisse First Boston.

Here are three areas that SEC investigators are looking at:

Discount rate: Companies use discount rates to figure out the present value of things they need to pay in the future. Think of it this way: $1 million in cash 10 years from now is worth less than $1 million in cash today. How much less? Well, that's where the discount rate comes in.

To place a current value on future pension payments, companies typically look to prevailing interest rates for high-grade corporate bonds. The way the math works, the higher the discount rate, the lower the current value of the future liability -- and the better funded a plan would appear.

"A small change in the discount rate can make a big difference in whether you look well-funded," said Jack Ciesielski, a Baltimore-based expert on pension accounting who provides research to institutional investors. And thanks to the quirky current accounting rules, changes in the rate may have generated accounting gains that boosted net income.

Many auto makers, including GM and Ford, have lowered their discount rates in the past several years, as interest rates have fallen. GM's discount rate in 2004 was 5.75%, down from 7.8% in 1999, in line with a portfolio of bonds rated double-A by Moody's Investors Service Inc., according to GM. Each year the discount rate has decreased, GM's liability and annual pension expense have increased. GM's financial filings note that a 0.25% decrease in its discount rate would increase its annual pretax pension expense by $160 million and raise its pension-benefit obligation by $2.3 billion, according to financial filings.

Scott A. Taub, the SEC's deputy chief accountant, said companies need to be able to justify the chosen discount rate. "What would trouble me in terms of selection of the discount rate is if a company selected or changed its discount rate in an attempt to manage earnings," he said.

Expected rate of return: Under accounting rules, companies use an expected, or assumed, return on pension assets, rather than an actual return, to help smooth the impact of market swings on their pension plans' value in their financial statements. If actual returns turn out to be greater, or lower, than the expected return, the effects are filtered into the annual pension expense over a period of years.

At GM, a 0.25% increase in the expected return on assets lowers the company's pension obligation by $220 million, according to its financial filings.

From 1999 through 2002, GM assumed an expected return of 10%, and it has assumed 9% since then. Actual returns have varied, from 18.1% in 1999 to negative 7.3% in 2003. The company's average rate of return over the past 15 years has been about 9%, according to GM.

The FASB may consider requiring companies each quarter to adjust a plan's assets and liabilities on their balance sheets to "fair value," eliminating the smoothing technique.

Health-care inflation: In estimating a company's liability for health-care benefits to current and future retirees, companies must estimate health-care inflation. Companies are supposed to take into account recent experience and trends, according to SEC officials.

As of December, GM, which is the nation's largest private provider of health care, used 10.5% for its current inflation rate and 5% for a longer-term rate, according to its financial filings. Small changes mean big swings: A one-percentage-point increase in the health-care trend rate would increase GM's liability for these benefits by $8.4 billion and increase the annual expense by $543 million, its filings show. A decrease of similar size would shrink the liability by $7 billion and the expense by $384 million.

SEC investigators want to know if companies at some point in the past may have used an artificially high health-care liability figure, then subsequently reduced it, a reduction that would have had the effect of boosting earnings.