



by Rick Wayman ([Contact Author](#) | [Biography](#))

In the article [Analyzing Pension Risk](#) I define pension risk and explain why it is important to assess this risk posed by a company's [defined benefit pension plan](#). Here in this article I present one way (but not the only way) that can help you evaluate and assess whether or not a company's pension exhibits a high risk of [shortfall](#).

Analyzing a company's pension risk should be as easy as reading the footnotes to compare what is owed (accumulated benefits due employees) to what is owned (the value of the portfolio). Unfortunately, thanks to complicated accounting and [IRS](#) rules, evaluating pension risk is a Gordian knot that is not easily unraveled.

However, there is a way to use information in the footnotes to evaluate pension risk. While it involves some work, this process will make you a more informed investor. The goal of this process is to cut through the accounting mumbo jumbo to estimate pension funding and cash risk.

The Process

In General Electric's (NYSE: GE) 2002 annual report, Footnote 6 contains the pension data we need. Under the "effect on operations" section it is disclosed that GE's pension plan contributed \$1.556 billion to pre-tax income (before payments for retiree healthcare and other benefits), or \$0.12 per share on an after-tax basis.

However, this amount was arrived at after using the smoothing techniques allowed by [generally accepted accounting principles](#) (GAAP). The table in Footnote 6 (shown in Table 1 below) shows that the \$1.556 billion was the result of the expected return of \$4.08 billion, the real costs and smoothing accounting techniques. It is these real costs that will be used to analyze the real cost of GE's pension plan.

Table 1: Pension Effect on Operations

(\$Billion, except per share data)	2000	2001	2002
Expected return on assets	3.754	4.327	4.084
Service Costs/benefits earned (1)	-0.780	-0.884	-1.107
Interest cost on obligation	-1.966	-2.065	-2.116
Prior service cost	-0.237	-0.244	-0.217
SFAS 87 transition gain	0.154	0.000	0.000
Net actuarial gain recognized	0.819	0.961	0.912
Income from pensions (2)	1.744	2.095	1.556
Retiree benefit plans cost	-0.478	-0.615	-0.750
Net cost reduction	1.266	1.480	0.806
(1) Net of employee contributions			
(2)After tax per share	\$ 0.12	\$ 0.15	\$ 0.12

In order to gauge the impact of "core" pension expenses on [EPS](#), you need to examine the real annual costs of a pension plan, namely service and interest costs. The service costs represent the pension benefits earned by the employees during that year, and in GE's case, that number is the net of employee contributions. The interest cost represents the interest that accrued on the unfunded part of the projected benefit obligation. Analyzing the impact of these costs in relative isolation helps analyze the impact of pension liabilities without the smoothing allowed by GAAP.

To determine the "real" annual cost of the pension plan, you need to back out the massaged number (in this case the \$1.556 billion) and add back the service and interest cost. The real annual, after-tax, per share cost of the pension plan in 2002 is \$0.38.

As shown in Table 2, this calculation increases the cost 16.7% in 2001 and 6.1% in 2002. This represents a total "swing" of \$0.50 from the GAAP EPS number. GE is unique because its plan contributed income whereas most plans add expense. Generally, when evaluating pension risk plans adding expense, you would add the periodic pension cost and subtract the service and interest costs to get the net effect on EPS, but in GE's case, you subtract everything:

Table 2: Adjusting EPS for Service and Interest Costs.

(\$Billion, except per share data)	2000	2001	2002
Remove accounting benefit	1.744	2.095	1.556
Add Service Cost	0.780	0.884	1.107
Interest Cost	1.966	2.065	2.116
Net Effect to income	-4.490	-5.044	-4.779
After tax amount	-3.100	-3.617	-3.828
After tax per share adjustment	(\$0.31)	(\$0.36)	(\$0.38)
		16.7%	6.1%

This adjustment reduces GE's EPS growth rate by 38%. As shown in Table 3, the GAAP EPS growth rate for 2002 was 2.9% versus the 1.8% that results from making the adjustments described above.

Table 3: EPS Comparison

	2000	2001	2002
GAAP EPS (1)	\$1.27	\$1.37	\$1.41
growth		7.9%	2.9%
Adjusted EPS	\$0.96	\$1.01	\$1.03
growth		5.0%	1.8%

(1) Diluted shares before accounting changes

What about Periodic Investment Gains?

This process does not factor in the return on plan assets for two main reasons. First, the above process focuses on the actual annual costs in order to gauge their impact on earnings. Second, the return on plan assets does not belong to the company but to the retirees. While an accounting convention may allow a company to net the costs against the returns, the company has no legal right to the returns. Factoring the return on plan assets into the process would distort the analysis.

If you wanted to include the return on plan assets, you would need to look at the disclosure of the Fair Value of Plan Assets. In GE's case, the actual loss on plan assets was \$5.25 billion (compared to the \$4.1 billion return that was expected). Including the actual loss on plan assets would reduce EPS by another \$0.42 (after taxes).

The Bottom Line

This approach analyzes the EPS impact of the hard (or undiluted by accounting practices) cost of defined pension plans on EPS. Focusing on the per share impact of annual service and interest costs

provides a clear view of annual costs that is unclouded by the actuarial assumptions and smoothing techniques allowed by GAAP.

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