PENSION AND POST-RETIREMENT BENEFITS: FINANCIAL FOOTNOTES, ACCOUNTING TREATMENTS, AND INVESTMENT ANALYSIS

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SBC Communications, Inc. was created from the breakup of American Telephone & Telegraph Company. It acquired the defined-benefit and post retirement benefit plan obligations of Southwest Bell. Dr. Carpenter requested her students to analyze SBC as a potential investment. An integral part of the study must include an analysis of the pension and retirement benefit obligations.

This case is intended for use in an upper level accounting class.

INTRODUCTION

"SBC was among hundreds of companies that last year updated key assumptions in their accounting for post-retirement benefits to bring estimates more in line with real-world trends." This statement helped to introduce an October 25, 2004 *Business Week* (Borrus, 2004) article on pensions, post-retirement benefits, and companies' ability to make adjustments in the assumptions they use to determine annual expenses and cash flows related to these items. In the same article, *Business Week* also noted that "Such changes, and the impact they can have on profits, have caught the eye of the Securities Exchange Commission."

For SBC, the effect was to reduce net income by almost $700 million in 2003. In addition to this accounting statement effect, footnotes in SBC's 10-K report indicated a $10 billion underfunding of post-retirement benefits, despite a charge of $1.7 billion to 2003 expenses. (SBC 10-K report, 2003)

Dr. Carpenter, a senior professor of accounting at a small southeast university, provided this information to her Investments class as part of the coverage of financial statement analysis and accounting rules. Her objective was to stimulate discussion about the analysis process and quality and complexity of information provided in financial statements and financial footnotes. She had invited her colleague, Dr. Winters, to participate by providing

Accounting expertise and perspective to the discussion. Together, they would lead students through a real company's treatment of pension and post-retirement benefits, accounting rules, and the issues which an investment analysis would need to examine.

PENSION AND POSTRETIREMENT BENEFITS: BACKGROUND

Dr. Carpenter began her comments by noting that the last 20 years had seen major changes in the structure of pension plans and post-retirement benefit packages offered to employees. Federal legislation had been enacted which introduced the 401-k plan as an alternative around which many companies had restructured their old pension plans. Although there were a variety of designs for the "modern" pension plan, the common effect was to shift from defined-benefit plans, which promised to pay specific dollar benefits to retirees, to defined-contribution plans, which promised only that a company would make a specific level of contribution to a plan. For the latter, the level and availability of the pension to be received by a retiree would depend upon how the contributions had been invested and how the investments had performed.

In the 1990s, another retirement benefit became the target of companies which found themselves facing rising costs for retiree healthcare benefits, particularly as the "baby boomers" could now see retirement on the horizon. Firms began to make changes in the benefits by increasing co-pays (out-of-pocket payments by retirees for prescription drugs and medical treatments), raising the cost of dependent coverage, requiring generic drugs, and excluding some kinds of treatments. By 2000, it was clear that the majority of company pension and post-retirement benefit plans were live targets for managerial reconfiguration.

The group of companies which still offered defined benefit plans was growing smaller. However, within this group were some of the most visible companies in the US economy. In most instances, the benefits packages had been negotiated with unionized labor forces and union management and members were generally unwilling to negotiate a change to a defined contribution plan. As the baby boomers could see retirement within 5 to 10 years, they were reluctant to give up what they had been promised by the companies.

Management saw the situation very differently. Accounting rules had permitted great flexibility in how the pension obligation was treated for accounting purposes. The result was that management of some companies had chosen to use optimistic return expectations for the pension funds, thereby reducing the level of contributions which had to be made each year. This same approach had also been applied to post-retirement benefit funding. The net result was an increasing number of companies with pension and post-retirement obligations which exceeded the funds set aside for these expenses. In 2003, Credit Suisse

First Boston (Stock, 2003) reported that S&P 500 defined-benefit plans were underfunded by $220 billion and other post-retirement benefits plans were underfunded by $309 billion. The study noted that there were 328 firms in the S&P 500 with defined-benefit plans; it also noted that underfunding in 27 of these "...could exceed 25% of their current market capitalization by the end of 2003..." (Stock, 2003)

Aside from debates about the accounting choices available to management in reporting and funding pension and post-retirement benefits, questions were being raised about management's motives for underfunding plans or implementing cuts in retirement benefits. According to *Business Week* (Borrus, 2004), a National Bureau of Economic Research study found evidence that "....some executives may deliberately monkey with pension assumptions for corporate and personal gain. The trio analyzed accounting for 3247 pension plans from 1991-2002 and found that companies tended to hike pension return estimates the year before making an acquisition or before a CEO exercises stock options." Additionally, some companies had shifted earnings from pension plans in years when those returns exceeded the "expected" rate and reported them as corporate earnings.

In a March, 2004 article, *The Wall Street Journal* presented examples of the benefits to IBM, Caterpillar, Whirlpool, and International Paper Co. from changes in other retiree benefits (Schultz and Francis, 2004). Post-retirement benefits had generally been funded "out of pocket" by companies. Therefore, as health care costs began to escalate over the past decade, the amount of funds to meet future retiree healthcare costs grew at double-digit rates, cutting into cash flow and profitability. Management's reaction was to find ways to shift the burden from the company to the retiree.

ACCOUNTING FOR PENSION FUND OBLIGATIONS AND POST-RETIREMENT BENEFIT PLANS

Dr. Winters then reviewed the accounting rules and regulations affecting pension plans and post-retirement benefit plans. She began by agreeing with Dr. Carpenter that the last two decades had witnessed major changes in the growth and structure of pension plans. Within the last 20 years pension funds had tripled in size and were now roughly equal to the size of Japan's gross national product. More than 60 million workers were covered by pension plans. Dr. Winter concurred with the observation that the group of companies offering defined benefit plans was growing smaller. Less than one third of workers were covered by defined benefit plans compared to more than two-thirds of workers who were covered by defined contribution plans.

However, she mentioned that there were additional reasons for the shift. First, government regulations made defined-benefit plans arduous and costly to administer. Because the obligation for contributing to the plan ends once the employee leaves the company, employers were increasingly unwilling to carry the risk of defined-benefit plans. An alternative interpretation of the shift in plans was that many employers were now motivated to attract new talent by offering more mobile defined contribution plans, in lieu of trying to "purchase long-term loyalty" with defined benefit plans (Spiceland, 2004).

She noted that the accounting treatment for defined benefit plans was considerably more complex than currently favored defined contribution plan. The *Statement of Financial Accounting Standards No. 87* is the primary source for generally accepted accounting pension rules (SFAS No. 87, 1985). The Standard defined three elements of a defined-benefit pension plan: 1) *employer's obligation* to pay retirement benefits in the future, 2) *pension plan assets* that are set aside from which to pay future retirement benefits, and 3) the *periodic expense* of maintaining the pension plan. The employer's obligation and the pension plan assets were not reported directly in the financial statements (balances were reported in disclosure notes).

However, the *periodic expense* (reportable on income statement and in notes) was a combination of both the changes in the employer's pension obligation and plan asset accounts. The pension obligation can be measured by three different methods and typically an actuary would derive and provide the numbers to the company accountant. The alternative measures included the 'vested benefits obligation', 'accumulated benefit obligation (ABO)' and the 'projected benefit obligation (PBO)'. The last two alternative measures (ABO and PBO) were also used to derive both the minimum pension liability that a company would report and the components of the periodic pension expense, respectively.

Dr. Winters continued: "It's been noted that an increasing number of companies with pension retirement obligations exceed the funds set aside for these expenses. How is a funded status determined? A pension plan is underfunded when the PBO exceeds the plan assets return on investments (e.g., dividends, interest, stock appreciation). An employer estimates the amount required to accumulate enough funds to pay the retirement benefits; the higher the estimate the less actually required to be contributed by the employer. Thus, if an estimate is greater than the actual return on plan assets, the pension plan will be underfunded. The Employee Retirement Income Security Act (ERISA) in 1974 required a minimum funding of plans; however, the limits are often less than full funding and may genuinely place employees' retirement at risk."

The accounting treatment for post-retirement benefits was similar to the accounting for pension benefits. For instance, the components (e.g., service and interest cost, return on plan assets, prior service cost, losses/gains) of the postretirement benefit expense were basically identical to those related to the pension expense. *Statement of Financial Accounting Standards* (SFAS) No. 106 dictated the accounting treatment for post-retirement benefit plans (SFAS 106, 1990). There are two related obligation amounts for post-retirement benefits. The expected postretirement benefit obligation (EPBO) is the estimated postretirement benefits (present value) derived by the actuary. This represents the amount expected to be received by the plan participants. The alternative is the APBO (accumulated postretirement benefit obligation). This method measures the obligation at a point in time, rather than the amount expected to be given to the plan participants. The APBO is conceptually similar to the projected benefit obligation (PBO) and is also an off-balance sheet obligation, only reportable in disclosure notes.

As with defined-benefit plans, the employer was required to make cash contributions for post-retirement benefits. However, when recording the post-retirement benefit expense the cash represents only the current year's costs, in lieu of future year requirements. The justification for this was that tax incentives discourage prefunding of retiree benefits (i.e., health care benefits). In addition, such benefits were not subject to the stringent ERISA funding rules applicable to pensions. The result of this underfunding is a cumulative underpayment, which is reported as a liability, "accrued postretirement benefit cost". Corporations with underfunding of pension plans often exhibited underfunding of post-retirement benefits.

THE COMPANY: SBC COMMUNICATIONS INC.

SBC Communications Inc (SBC). was created out of the breakup of American Telephone & Telegraph Company (AT&T) into the so-called regional "Baby Bells". Southwest Bell had been the subsidiary serving the southwestern United States. With the breakup of AT&T, the telephony industry experienced a period of divestiture, merger and acquisition. Each of the Baby Bells sought to reconfigure itself. Southwest Bell was no exception, reaching out to acquire Ameritech, Southern New England Telephone, and Pacific Telesis in 1990s. It also entered a joint venture with Bellsouth Corp. to form Cingular Wireless. For 2003, SBC Communications, now the name for the parent company, reported almost $41 billion in revenues and $8.5 billion in net income. Revenues had declined from a high of $51.4 billion in 2000; net income was at its highest level in 5 years, although it followed a steep decline in 2002.

SBC PENSION PLAN

SBC was a unionized company. It acquired the defined-benefit and post-retirement benefit plan obligations of Southwest Bell and its acquired companies. Financial footnotes to the 2003 10-K report indicated a "Benefit obligation at the end of year" equal to $27.6 billion. The "Fair value of plan assets at the end of year" was $28.2 billion, including an employer contribution for the year of $500 million. In the balance sheet, the company recognized a $8.5 billion Prepaid Pension Cost as a part of Other Assets.

In the footnote, it was noted that the assumed "discount rate for determining projected benefit obligation" was 6.25%. This represented a reduction in the rate previously assumed. The company also expected the pension plan assets to generate a long-term rate of return of 8.50%, down from the previously assumed 9.5%. These changes in assumptions affected the magnitude of projected pension obligations and the projected value of the pension fund portfolio.

SBC POST-RETIREMENT BENEFITS

The financial footnote for post-retirement benefits indicated that the projected post-retirement benefits obligation was $27.2 billion. The "unfunded status (fair value of plan assets less benefit obligations)" was $20.3 billion. The "accrued postretirement benefit obligation" was $12.7 billion, which was reported as a long-term liability on the balance sheet. While it indicated an expected positive return on plan assets, the 2003 Pension/Postretirement Benefits footnote indicated a loss of more than $500 million on those assets and a loss of $689 million in 2002. In the Equity section, SBC also included a $1.1 billion deduction, which was labeled "Additional minimum pension costs adjustment."

Additionally, the company reported $1.7 billion in benefit expense in the Income Statement. This footnote also indicated that changes in medical coverage applying to nonmanagement employees would take place in 2005, thereby reducing SBC's benefit costs by $300 million to $600 million. This continued a practice from previous years when it raised co-payments and retiree contributions. Further, because of a provision in the Medicare Act, the company also included a projection of $1.6 billion in future benefit obligations.

PERSPECTIVE ON INVESTMENT ANALYSIS

"As an investment analyst, you must be able to comb the financial statements and financial footnotes of a company to identify factors that can help or hinder the firm's future financial performance," Dr. Carpenter said to her students. "Not only do you have to understand traditional ratio analysis, you have to understand what the descriptions and numbers in the financial footnotes mean. You also have to ask questions about management's intent as it chooses specific kinds of accounting treatments and the consequences to themselves and to investors.

As an investment analyst, you need to consider behavior, such as manipulating data before an acquisition is made or before the CEO exercises stock options. You need to question the potential for litigation when companies begin to renege on prior commitments, particularly when management's compensation packages grow at double-digit rates. You need to raise questions about the morale in the firm and the implications of changes for human resource management as employees begin to question the credibility of management and its commitments to them.

The survival of a company is not dependent solely on the quality, price and availability of its products or services. Ultimately, human resources, management, technology/R&D, production, and financial and accounting decisions can affect the survivability of the company as much as any new product or service. Companies are living creations and accounting provides opportunities for management to alter the measures of health of the organization. An investment analyst must be willing and able to dig deeply and to challenge the simplistic interpretations of financial statements.

In summary, competent investment analysis requires multiple skills and knowledge of many different areas. I contend that an investment analyst whose only area of expertise is a technical skill, such as financial ratio analysis or accounting, is poorly prepared and will ultimately increase the risks to those who make use of their recommendations. Investment analysts need to drawn on knowledge or understanding of marketing, management, finance, accounting, production, human resources, sociology, psychology, economics, political science, engineering, technology, and science. A gifted investment analyst will have knowledge and interest, not necessarily in depth expertise, in multiple areas of the world and bring those to bear in the investment process. Analysts who narrow their focus to simplistic and easily replicated processes may enjoy short-term success but rarely will be able to develop a sustainable track record."

IMPLICATIONS OF PENSION AND RETIREMENT BENEFITS FOR SBC

Dr. Carpenter then requested students to begin Phase 1 of the process of analyzing SBC Communications as a potential investment. Analysis should include pension and retirement benefits issues supplemented by consideration of the value of different kinds of information, the potential for key issues to be discovered in the financial footnotes, and the effects of different accounting treatments in creating financial statements.

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