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Pensions Accounting and the Impact on Investors

Proper understanding of Financial Statements

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Analyst certification and required disclosures begin on page 14

Key aspects of IAS 19

- Service cost an operating expense, interest cost and expected asset return either operating or financing
- Choice of corridor method or immediate recognition of actuarial gains and losses
- Liabilities measured using high quality corporate bond rate, salary growth included, scheme costs generally excluded
- Detailed disclosures but only aggregate percentage expected return on assets is required

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Main focus of analysts

- Income statement data largely taken as given
  - Little attempt to adjust figures other than ensuring interest cost and expected asset return are not in operating
- Balance sheet liability treated as quasi debt
  - Little attempt to investigate assumptions and adjust
- Awareness of pension risk including longevity and asset allocation
  - But risk is less of a focus in equity analysis than cash flows and profit
- Future cash funding costs regarded as important
  - Particularly changes that may be mandated due to trustee / regulatory activity
- Increasing interest in buyout valuations
  - Although mainly in the context of M&A

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Income statement charge

- Pensions regarded as a financial liability and hence interest cost and expected return excluded from operating result
- Past service cost, curtailments and settlements treated as (potentially) non-recurring operating expenses
- Amortisations under corridor method should be excluded from performance metrics – although not by all analysts
- Expected return often included without adjustment
  - We recommend excluding the ‘equity spread’ when calculating performance metrics
  - Some UBS analysts do this where impact is material – eg BT

Example of adjusting expected asset return

£mReported	Adjusted	
Operating profit	254	254
Other pre-tax	-106	-106
Pens exp. return	272	**217** (2)
Pens interest	-321	-321
Tax	-46	-29
Earnings	53	15
Adjusted Earnings(1)	105	67
Adjusted EPS(1) (p)	6.5	4.1
P/E		14.7x23.1x

(1) Pre-exceptional earnings

(2) Recalculated using the discount rate as the expected % return

Should all ‘smoothing’ be removed?

- Corridor method - YES
  - Current period allocations of prior period gains and losses have no relevance
  - But value changes would need to be reported separately from the rest of profit
- Expected asset return – NO (in my view)
  - Expected return needed to enable forecasts of likely cash funding
  - Case for presenting a net interest cost on net funding position (ie expected return equals discount rate – see above)
  - IASB taken tentative decision to remove expected return

Balance sheet liability

- Analysts increasingly aware the BS figure may not be adequate
  - Actions of pension regulator
  - Impact of pensions on M&A, particularly private equity
- But analysts are not clear about how to adjust
  - For general analysis focus balance sheet figure used
  - In M&A attempt is made to identify addition 'cost' that might be imposed
- My view
  - Risk free discount rate
  - No anticipation of salary growth
  - Include scheme running costs

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Performance measurement for equity analysis and valuation

A recent report from UBS proposes …

- An approach to financial statement presentation that is consistent with how businesses are actually analysed and valued
- A logical, conceptually based and economically relevant measure of earnings
- Asset and liability measurement that is consistent with the way in which this information should be used in equity analysis
- Use of fair values in a way that informs about performance rather than creates confusion for investors, as is too often the case at present
- Recognition that financial statements are about communication between management and investors, and suggestions on how this can best be facilitated

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For illustrative purposes only

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UBS report – Suggested presentation of pensions

Table 7: Summary of the proposed presentation of pension related gains and losses

Operating activities	Total	Management highlighted items
Operating expenses	Service cost Prior service cost Curtailments and settlements Gains and losses due to changes to assumptions relating to the measurement of the liability such as changes in longevity (but excluding changes to movements in the discount rate)	Any operating items that a company chooses to highlight due to for example their abnormal size or non-recurring nature
Investments and non-operating assets	**Market yield**	**Fair value changes**
Net return on the funded element of pensions	Expected market yield on pension fund assets	Difference between actual return and expected market yield on pension fund assets
	Interest accruing on the funded portion of the gross pension obligation	Impact of discount rate changes on the funded portion of the gross pension obligation
Financing and treasury	**Market yield**	**Fair value changes**
Interest expense on unfunded element of pensions	Interest accruing on the unfunded portion of the gross pension obligation	Impact of discount rate changes on the unfunded portion of the gross pension obligation

Source: UBS

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Some comments from UBS sector analysts

- "Sell-side generally is driven by what they perceive the market to be interested in on their stocks at particular point in time. So when pensions make more headlines, there is more analysis on pensions; when private equity deals are in vogue, there is more analysis on cash flow, pension deficit, debt structure of companies etc; when cash flow yield is fashionable valuation metric, a lot of analysis on FCF generation etc."
- "Pension costs are a cost like any other. The important thing is the impact on net cash flow ….. DCF analysis should already include the pension funding cost as a cash flow item"
- "As far as pension deficits are concerned, these are generally ignored in everyday conversation if they are less than 5% of market cap; and I guess in any case they are captured in the P&L finance charge under FRS17 and IAS19. But I would definitely include the net deficit in EV calculation, and deduct from DCF-derived EV to get to equity fair value."

Some comments from UBS sector analysts

- "I don't adjust for pension investment policy, since I assume (possibly wrongly) that trustees would ensure that the investment policy is appropriate"
- "Investing in bonds has to make sense. A pension fund with young members might be better off investing in equities (although it has to be a balance investment - 40-50% in equities), whereas a pension fund where only 1-2% of the members are still active and the great majority are retired investing >85% in bonds might be a lot more appropriate."

Disclosures

Global ratings: Definitions and allocations

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Buy 1	FSR is > 10% above the MRA, higher degree of predictability	**Buy 2**	FSR is > 10% above the MRA, lower degree of predictability	**Buy**	40%	37 %
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	**Neutral 2**	FSR is between -10% and 10% of the MRA, lower degree of predictability	**Hold/Neutral**	42%	36%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	**Reduce 2**	FSR is > 10% below the MRA, lower degree of predictability	**Sell**	12%	28%

1: Percentage of companies under coverage globally within this rating category.
2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.
Source: UBS; as of 31 March 2007.

Key Definitions

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).
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