

## **Pensions, Pension Interest and Standard & Poor's Core Earnings**

Following the release on October 24, 2002, of updated and expanded materials on Standard & Poor's Core Earnings, Standard & Poor's has received some questions on the treatment of pension costs in Standard & Poor's Core Earnings. This note explains in layman's terms how Standard & Poor's Core Earnings treats defined-benefit pensions. A defined-benefit pension plan pays a pension based on years of service and salary levels. It is different from a 401(k) plan or a defined-contribution plan. These adjustments do not apply to 401(k) plans and other defined-contribution plans.

Standard & Poor's Core Earnings focuses on the results of a company's core business. It excludes items, such as litigation costs, that are outside the core business, and includes items, such as employee stock option grants, that are part of the core business. In looking at pension costs, Standard & Poor's Core Earnings tries to:

- Separate the fortunes of the core business from the fortunes of the pension plan
- Identify pensions costs, since the overall pension program is part of employee compensation
- Exclude pension fund gains.

This approach is very different from that taken by the Financial Accounting Standards Board (FASB) in its pension accounting rules in FASB 87. FASB combines the pension fund with the company's overall business by calculating the net gain earned by the pension fund after all pension-related expenses, and then includes this gain in the company's net income. Further, because the net pension gain depends on the stock market, and market returns are volatile, FASB replaces the actual pension fund returns with an expected return.

Standard & Poor's Core Earnings takes a different approach. Pension costs consist of Service Cost and Interest Cost. Both are annual costs and are the same as those defined under FASB 87. When an employee is covered by a defined-benefit pension plan, the annual Service Cost is the increase in the present value of the future pension obligations due to an added year of service and salary. In effect, if someone works for another year, they will receive higher pension payments and the service cost is simply deferred compensation. As each year passes, the time when the future benefit obligations must be paid becomes one year closer and the present value of those obligations increases with the passage of time. The increase in the present value is the Interest Cost. If the pension fund is properly managed, it should earn enough each year to cover the annual interest cost. If the fund consistently fails to cover the interest cost, it will become more and more underfunded over time. These two pension-related costs arise because the company offers its employees a defined-benefit pension plan as part of overall compensation. Therefore, these costs are charged against Standard & Poor's Core Earnings.

The assets in the pension plan and the earnings of those assets are only available for paying pension benefits. These assets are not company or shareholder funds, and their earnings should not be included in the company's net income.

In calculating Standard & Poor's Core Earnings from As-Reported earnings, two adjustments are made:

- All the pension gains and expenses in FASB 87, except Service Costs and Interest Costs, are reversed. This eliminates the FASB 87 calculation of expected pension returns, but leaves the two key pension costs as charges against income.
- Interest Costs are then compared to the actual return earned by the pension plan assets. If the actual return covers the interest cost, then the pension plan is assumed to cover these costs and there is no charge to Standard & Poor's Core Earnings. However, if the actual return does not cover interest costs – because the financial markets were weak or because of the way the fund is managed – then these

costs are charged to Standard & Poor's Core Earnings because the company is ultimately responsible for them.

This last item has occasioned some comments. In most years, most companies are likely to cover their interest costs with the actual returns on the plan. However, in some periods – such as the current bear market – the comparison of interest costs and actual returns results in added charges against, and a lower number for, Standard & Poor's Core Earnings. For the S&P 500 in the 12 months ended June 2002, Standard & Poor's Core Earnings were \$18.48. Had there been no charge related to interest costs, they would have been \$22.98. By comparison, As-Reported earnings for the same period were \$26.74. The table below shows these figures quarter by quarter for 2001:1 through 2002:2.

In other words, simply adding back the \$4.50 interest cost provided in Standard & Poor's Core Earnings data takes out the volatility of pension interest costs and provides the adjusted Standard & Poor's Core Earnings number that those accustomed to the current GAAP accounting may prefer. Standard & Poor's calculation of pension interest cost, however, provides an alert – in cases where pension interest costs are charged – that an underfunded plan may be ahead. The company in that case will have to penalize next year's earnings and cash flow to fund the plan.

Clearly, the size of the interest cost charge depends on both the pension plans and the financial markets – the current three-year bear market is a severe stress test for pensions and corporate earnings. Standard & Poor's estimates that if the S&P 500 returns about 7.8% or more in 2003, there will not be any pension interest cost charge against Standard & Poor's Core Earnings for the S&P 500.

One result of this treatment of interest costs and actual plan returns is to increase the apparent volatility of a company's earnings by incorporating market-generated results in the calculation. In theory, this would be avoided by replacing the actual return with an expected return or a moving average extending over

several years. However, as the stock market's performance in the last decade or so has demonstrated, this could easily leave analysts with results that conceal significant pension funding questions. Standard & Poor's feels that a preferred approach for analysis to avoid the apparent volatility that this treatment of pension interest costs may introduce is to exclude interest costs from the calculation. In effect, this is the same as assuming the pension plan can cover the interest costs. However, it also frees an analyst from needing to consider or project the overall market while assessing the financial condition of a single company. Standard & Poor's presentations of Standard & Poor's Core Earnings will show the interest costs as a separate item to allow analysts to exclude them if they desire. Of course, in most years with modest gains in the stock market, this is not expected to be an issue.

<b>S&amp;P 500 Earnings Per Share</b>					
	Operating Earnings	As-Reported Earnings	Standard & Poor's Core Earnings	Standard & Poor's Core Earnings Before Pension Interest Expense	Pension Interest Expense
	\$/Share				
2001:1	10.73	9.18	6.15	7.30	-1.15
2001:2	9.02	4.83	4.15	5.29	-1.14
2001:3	9.16	5.23	3.55	4.69	-1.14
2001:4	9.94	5.45	2.92	4.05	-1.13
FY 2001	38.85	24.69	16.76	21.32	-4.56
2002:1	10.85	9.19	6.62	7.74	-1.12
2002:2	11.64	6.87	5.40	6.51	-1.11
4Q's to 2002:2	41.59	26.74	18.48	22.98	-4.50
Trailing P/E 6/30/02	23.8	37.0	53.6	43.1	

-The Standard & Poor's Core Earnings Committee, October 31, 2002.