

COMMENT

*New pension reporting rules will be painful***Debt lines about to get a lot heavier****AL ROSEN**

Ever so slowly, Canadian companies are being forced to improve the clarity and transparency of their financial reporting, although not, as you might expect, because of homegrown efforts. Rather, it is once again the result of pressure from U.S. reformers.

Starting this December, the United States will require that companies with defined benefit pension plans recognize the funding status of those plans on their balance sheets. The funding status is simply the assets of the company pension plan minus the estimated obligations. Seems fair enough, doesn't it? Report the net fair value of the pension plan on the balance sheet. So, why are so many companies troubled by this new development?

Think of a flock of chubby chickens looking for spots on an already crowded roost. Ugly details that were once tucked away in those unreadable notes to the financial statements will soon be out in plain sight.

By some estimates, the vast majority of U.S. defined-benefit pension plans are under water, which means the debt lines of innumerable corporate balance sheets are about to get a whole lot

heavier.

Take Nortel Networks Corp., for example, which follows U.S. accounting and will have to add considerable leverage to its balance sheet under the new rules. If we combine the last reporting of the company's pension plan with its most recent balance sheet, the effect is not pretty.

Back in July, we estimated that the new accounting rules would shift US\$1.5-billion of debt on to Nortel's balance sheet. That could leave the company with total debt of almost US\$5.3-billion, a 40% increase. Nortel's debt-to-equity ratio would almost double to 8:1, a level roughly three times the average of its telecom equipment peers.

Because only a few Canadian companies report using U.S. accounting rules, most will escape unscathed until Canadian rule-setters catch up yet again. But that eventuality shouldn't matter to Canadian investors because they should recognize the inevitable and anticipate the valuation impacts today.

We have been making these types of valuation adjustments for years, long before highlighting the coming U.S. rule changes for our clients back in April. Furthermore, academic studies suggest that institutional investors already pay heed to pension deficits when it comes to valuation. In short, investors need to be concerned regardless of whether a company uses U.S. or Canadian accounting.

And Nortel is far from the only

pension-challenged company in Canada. Take Bombardier, the pillar of Canadian aerospace. For the fiscal year ended Jan. 31, the company reported shareholders' equity of US\$2.4-billion. We estimate under the new U.S. rules, Bombardier would have added \$1.2-billion in pension liabilities to the balance sheet, cutting its shareholders' equity in half.

Bombardier follows Canadian accounting rules, so it won't actually add the debt to its balance sheet at the end of this year. But clearly, this shouldn't matter if investors fully absorb the financial information that is out there. The problem is that they're not absorbing it, because it's not in plain sight until some resourceful independent research outfit (ahem) makes the convoluted adjustments using the information that is scattered throughout the notes to the financial statements.

In that sense, the new U.S. rules should provide a lot of clarity for investors, who will be much better able to figure out which chickens are likely to lay eggs once those pension deficits hit the balance sheet. That's even before considering the impact that the newly recognized balance sheet debt could have on everything from debt covenants to management compensation contracts. Some loan covenants require companies to keep to specific levels of capitalization in order to pay dividends or to qualify for additional financing. There's even a risk that companies could slide into default status, in which case their loans would fall due.

There's no question that Nortel and Bombardier represent the ugliest side of pension reporting in Canada. However, that hardly means the issue is isolated to just a few companies. In fact, that misconception was the principal reason we looked at all 132 companies in the TSX composite index with defined-benefit plans earlier this year. The valuation impacts are quite interesting.

For example, we think that Canadian Pacific Railway is currently fairly valued at around \$53 per share. But without its large pension plan deficit, the company could be worth \$66 per share. It just so happens that the average target price of the 12 other analysts on Bloomberg is \$66 per share. So, it's seriously debatable whether investors are considering off-balance sheet obligations in their current valuation estimates, or whether they are waiting for the debt to be dumped in plain sight before finally reacting.

We happen to think that investors can gain a serious advantage by examining the pension plan details of Canadian companies before they inevitably hit the balance sheet in the next few years. Once again it seems, thanks to U.S. accounting reformers, many things will come home to roost.

Financial Post

■ Al Rosen is a forensic accountant at Accountability Research Corporation, an independent equity research firm. alrosen@accountabilityresearch.com