



Time bombs

Buried in company financial statements, underfunded pensions can blow up in investors' faces

Tick, tick, tick. Which of the pension time bombs will explode first? The underfunding of some public companies' pension plans has received some, but not enough, serious attention from investors.

Underfunding is when the estimated obligations of a company's pension plan are less than the estimated value of its assets. For instance, Bombardier Inc.'s reported pension plan obligations are US\$6.2 billion, whereas its reported plan assets are just US\$3.9 billion. The difference of US\$2.3 billion is called the pension plan's underfunded status.

Many investors remain unaware of this serious obligation because the US\$2.3-billion gap is obscured, and also buried, in the company's financial statements. It is what's called an off-balance-sheet obligation, which means it falls off the radar screen of most investors.

The underfunded status of a plan can have many consequences, including the potential need to inject cash contributions into the plan. That, however, generally remains an issue for just a minority of public plans. What should interest investors most is the pervasive obfuscation that exists in the majority of pension plans with respect to the misstatement of the funding gap, and the impact that this has on everyday valuation and share prices.

I mentioned that the funded status is a function of two estimates (the value of the assets and the obligations). In fact, there are dozens more estimates and assumptions that go into reporting a company's funded status. Many of these estimates are made by company executives, and are therefore open to manipulation if it means reporting better financials. In short, some companies are underestimating their reported expenses and liabilities by a significant amount that cannot be ignored by investors.

Making adjustments for these misstatements and correcting market values can be very difficult, and is best left to professional analysts. We detailed these crucial adjustments for all the companies in the S&P/TSX composite index in a recent report for our institutional investor clients.

While that report is too complex to summarize here, I want to leave you with one valuable take-away. It is relatively easy for you to check the underfunded pension plan status of some of your main investments. Simply check the financial statements in the annual



Hidden funding gaps can have an impact on valuation and share prices

report for the note that discusses the pension plan. The company will report a detail of its assets and obligations at the end of the prior year, with the difference being the underfunded or overfunded status. If the underfunding is a significant amount, you simply need to ask your investment adviser or broker whether they considered the sizable off-balance-sheet obligation when valuing the company. You would be surprised how often advisers and analysts are unaware that a problem even exists, never mind the impact that it can have on the share price of the company.

Off-balance-sheet obligations can affect share prices in many ways, and might even account for a company's lagging performance, despite all other factors seeming normal. A large, unrecognized liability can impact leverage and influence the earnings discount or premium attributed to a company. If you prefer cash flow, EBITDA, or operating profit as the basis for valuation, the problems are similar. Estimated cash flows are discounted by a company's weighted average cost of capital. If that rate does not reflect the off-balance-sheet pension obligation, the company could end up being significantly overvalued.

The final step would be to make sure that the company's reported underfunded status reflects reasonable management estimates. I mentioned earlier that the funded status of most companies should be adjusted in many key areas. These complex adjustments, however, are beyond the scope of this column. Nevertheless, investors can make a serious difference by simply questioning their advisers on whether they considered such crucial valuation adjustments. In my experience, many advisers enjoy questions from their clients, and learning about new areas of analysis, especially when they can have such a significant impact on share values. □

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