

New rules will confuse investors

Sean Silcoff, Financial Post

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If you ever want something made simpler, don't trust accountants to do it for you.

The fraternity of bean counters recently decided to force public companies to come clean on accounting for the massive pension deficits many ran up after stock prices and interest rates fell sharply earlier this decade. The changes to accounting standards took effect in the 2006 fiscal year for firms that report in the United States (including Alcan Inc. and other Canadian firms), to be followed in Canada this year.

The result is supposed to be greater transparency for investors. The reality will be a lot of confusion. Companies may want to print "Don't Panic" on their annual reports, a la Hitchhiker's Guide to the Galaxy, before sending them out.

Investors will be greeted with shock when they turn to the financial statements. Under the old rules, only part of the pension deficit made it onto the balance sheet, while the full deficit was cited in accompanying notes. Now the whole thing will sit on the balance sheet, increasing liabilities and reducing retained earnings and shareholders' equity.

The effect will be huge for some. Had the rule been in place, Nortel Networks Corp.'s \$2.9-billion pension deficit would have cut 63% off shareholders' equity as of Dec. 31, 2005.

Peter Martin, director of accounting standards with the Canadian Institute of Chartered Accountants, the accounting rule setting body in Canada, says it's good to put it all out there, since pension dues impact a firm's health: "Better information leads to better decision-making."

Is it better? Actually, it is too much information, and not enough.

Companies don't have to cover pension deficits in one lump, but can make it up with extra payments over a few years.

This is where things get loopy. It turns out there are two types of pension deficits: those used by accountants, and those by regulators. The differences are significant.

For regulators, the key is what it would cost a firm to cover its obligations if its pension plan went out of business now. The concern is longer-term for accountants: What is the deficit worth today, assuming the plan stays open, taking inflation into effect? As a result, accountants come up with a much higher figure.

Take Alcan: In 2005, it had a \$3.1-billion pension deficit, according to the folks with the green visors. The civil servants counted just \$1.7-billion.

The accountants say their number is better and belongs on the balance sheet, since most pension plans aren't at death's door. The problem, says Veritas Investment Research analyst Dimitry Khmel'nitsky, who wrote two reports on the changing accounting standards last fall, is that the amount companies have to pay to catch up to their shortfalls is based on the regulatory

deficit. Alcan isn't paying back the \$3.1- billion pension deficit that would stare investors in the face under the new rules, but the one barely half that size, that won't.

"The whole pension deficit problem is overblown [as] the accounting distorts the magnitude of the problem," Mr. Khmelnitsky says.

Either way, if the regulatory deficit is so important to cash flow, you would think the accounting profession would have tightened up disclosure on that as well. But under the new rules (still in the works in Canada), there is no requirement to disclose that deficit, nor the size of contributions firms must make to make up the deficit. They don't have to reveal the assumptions behind the pension calculations, either.

Veritas says that information would be of great use. Not so, says Mr. Martin of the CICA. Veritas "would probably have an insatiable appetite for information," he says dismissively of the forensic accounting firm. "Just because one or two people think it's nice information to have, that's not usually the basis we use to develop standards."

Besides, he says, sharp analysts will be able to figure out what they need to know from what is in the financial statements. "General investors, we don't generally believe, will read an annual report cover to cover," he says. "The expectation is [they] rely on analysts to do the work for them."

That is not a unanimous view across the profession, and it's not difficult to imagine a few investors freaking out when those annual reports arrive. That could have a huge impact: Faced with irate shareholders, companies may move away from managed, or "defined-benefit" pension plans, leaving their employees to manage their retirement funds themselves, a troubling trend already well-established and gaining traction in Canada.

"Shareholders will ask the question, 'Why are you in this business'" of managing pension plans, says Michel Methot, Alcan's chief actuary. "The collateral damage will be done to [these] plans. Companies will be less interested in sponsoring defined-benefit plans, when it adds so much volatility to the balance sheet and complexity to investors."

ssilcoff@nationalpost.com

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