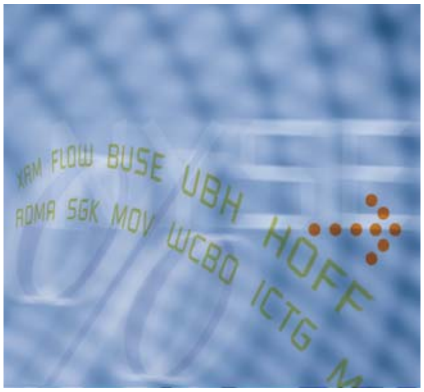


Earnings Quality Analytics

# Issue Commentary

Analysts: Nick Gibbons and Dr. Michael Williams

15 July 2010

### Some firms have huge pension shortfalls obscured by favorable assumptions

2008 saw a massive erosion in the value of defined-benefit pension plan assets, creating material pension deficits for many firms. While asset balances rebounded in 2009, many firms continue to face significant funding shortfalls. These shortfalls can significantly dilute equity and reduce future earnings and cash flows.

Unfortunately, the arcane rules of pension accounting and the discretion allowed in the choice of actuarial assumptions can result in many companies understating the magnitude of their pension shortfalls. For this *Issue Commentary*, we systematically analyzed 2009 fiscal year-end pension disclosures for hundreds of U.S. firms with material pension-plan obligations.

From this analysis, we identify a set of seven firms that have made questionable pension-accounting assumptions that may disguise the true magnitude of their obligation. As a result, the balance sheet may not provide an accurate portrayal of their financial condition, while their future earnings and cash-flow streams may be at risk for unexpected declines.

This is a follow-up of a similar *Issue Commentary* published one year ago. The firms highlighted in that report underperformed the market by an average of 5% over the following six months (10% annualized).

| | |
|---|---|
| **AMR Corp. (AMR)** | *Page 11* |
| The company's high discount rate may be causing its PBO to be understated by as much as 45%. We further believe that the high assumed rate of return on plan assets is distorting the true economic expense for the company's obligations. | - |
| **Eastman Kodak Co. (EK)** | *Page 12* |
| While EK has over $2.9 billion in actuarial losses recorded in AOCI and its plan is underfunded by $1.12 billion on an as-presented basis, the company has been reporting pension <u>income</u>. We view the benefit to earnings as unsustainable, as it does not reflect economic reality. | - |
| **The Goodyear Tire & Rubber Co. (GT)** | *Page 13* |
| On an adjusted basis, we believe that the company's pension funding deficit is more than <u>double</u> the as-presented deficit of $2.72 billion. As a result, we believe that the company will have to continue to contribute significant resources to the plan for the foreseeable future. | - |
| **ITT Corp. (ITT)** | *Page 14* |
| It appears that the company's pension expense may have been significantly understated as result of an expected return assumption above the company's already outsized assumption of 8.87% (which ranks in the 98th percentile of all companies in this analysis). | - |
| **Lockheed Martin Corp. (LMT)** | *Page 15* |
| On an adjusted basis, the company's unfunded obligations are $25.0 billion. We further believe that the company's sustainable pension expense may be closer to $2.0 billion per year. | - |
| **Macy's Inc. (M)** | *Page 16* |
| We believe that the company's sustainable pension expense during 2009 may have been understated due to a higher assumed rate of return on plan assets than the company's disclosed rate of 8.75% (which ranks in the 94th percentile of all companies in our study). | - |
| **The New York Times Co. (NYT)** | *Page 17* |
| The company's discount rate assumption ranks in the 94th percentile of all companies in our study. After adjusting for a lower discount rate, we believe the company's PBO may be 49% higher than presented. | - |

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**Pensions Still Suffering From Impact of 2008**

## Introduction

2008 was a difficult year for companies offering defined-benefit plans to their employees. According to a survey of U.S. firms, the median rate of return on plan assets during CY2008 was a dismal -23.8%.[1] Diversification was no protection either, as nearly every type of investment commonly held by pensions lost significant value, including stocks, bonds, and real estate. During 2009, the median return on plan assets was 19.1%, not nearly enough to offset the losses recorded in the prior year.[2]

A year ago (07/07/09), we published an *Issue Commentary* that involved a systematic review of pension concerns at hundreds of firms with a particular focus on nine companies whose pension accounting seems especially problematic to us. In this *Commentary*, we review the status of our highlighted firms from last year and identify seven new companies whose pensions currently raise significant concerns.[3]

We continue to focus on the variation in the key assumptions used to estimate a firm's pension liability for financial-reporting purposes. These can distort the underlying economic reality, particularly as plan assets have yet to return to their beginning-of-2008 balances. In this regard, our goal in this *Issue Commentary* is to identify a subset of U.S. firms that we believe may face obligations that are substantially greater than the liability reported on their balance sheets.

> Note: We do <u>not</u> attempt to identify firms that may have violated generally accepted accounting principles (GAAP) in computing pension expense, pension assets, or pension liabilities. Our sole focus is determining whether the reported obligation and pension expense (or income) appears consistent with our estimate of the underlying economic obligation.

In identifying firms for analysis, we apply a systematic approach to remove as much discretion as possible in estimating the economic value of each firm's pension obligation. These estimates are used to identify firms that may face relatively larger shortfalls and greater exposure to future increases in pension expense and related cash contributions.

The selection process yielded seven companies that we believe may have the greatest disparity between the economic value of their pension obligation and the net liability (including amounts stored in "accumulated other comprehensive income" or AOCI ) reported on their balance sheet. We focus on this latter group because there may be a greater risk of share mispricing due to a failure of the market to discount the full economic value of their pension obligations.

[1] We only include firms with fiscal years matching the calendar year to ensure comparability.
2 On an absolute basis, most of the 2008 losses were recovered in 2009, but most firms remain well behind their cumulative expected returns.
3 In addition to the domestic focus in these *Issue Commentaries*, we have applied similar analyses to several European companies in various *International Earnings Quality Alerts*, most recently for Invensys PLC (LSE:ISYS), published 07/14/10.

The remainder of the report is organized as follows: The next two sections provide a brief introduction to pension accounting under U.S. GAAP and discuss two valuation assumptions that may be used to reduce a firm's pension liability relative to economic reality. The third section describes the statistical methodology used. The fourth and final section focuses on seven firms that we believe may be mispriced by the market as a result of a mismatch between the pension liability reported in the financial statements and our estimate of the true economic value of the obligation.

## A Brief Primer on Pension Accounting

The following discussion reprises an overview of salient feature of pension accounting, under U.S. GAAP and IFRS that was originally published in our 07/07/09 *Issue Commentary*.

### DEFINED-BENEFIT PLANS VS. DEFINED-CONTRIBUTION PLANS

There are two general types of pension plans commonly employed by U.S. firms: defined contribution and defined-benefit. The primary difference between the two types of plans is how the company's obligation is defined. In a defined-contribution plan (such as a 401K plan), the firm provides funds (or matches contributions) that employees invest themselves. Since the employees bear all future risks on the investment (including whether the resulting asset is sufficient for retirement), the company's obligation is limited to the amount of *contributions* it has committed to provide. In contrast, in a defined-benefit plan, the firm invests money itself to provide for future payments it has promised to employees when they retire. Thus, the company's obligation is the actual (but uncertain) stream of future payments it must ultimately provide to employees when they retire.

Given their relative simplicity, the accounting for defined-contribution plans is simple. The contributions are expensed as incurred (i.e., as employees earn the contributions), and the company faces no liability beyond any contributions currently payable to the plan. The accounting for defined-benefit plans is much more complicated, however, as the company must estimate the present value of its future obligation, the cash contributions required to fund the obligation, and the economic cost of providing the pension benefit.

### ACCOUNTING FOR DEFINED-BENEFIT PLANS

The accounting rules for defined-benefit pensions under U.S. GAAP are specified in Statements of Financial Accounting Standards (SFAS) 87 and 158. The accounting for pensions is convoluted, due in large part to a desire to shield net income from large year-to-year changes in pension asset values, but also due to the use of actuarial assumptions in making predictions that in turn directly affect financial-statement presentation.

There are two basic components that must be valued in determining the net asset or liability associated with a firm's defined-benefit plan. The first component, the projected benefit obligation (PBO), is an estimate of the present value of all future benefits that the company is obligated to provide to past and present employees as a consequence of services *already* provided by those employees.[4] The second component, plan assets, consists of all funds contributed to the plan plus (minus) any gains (losses) on related investments.

The accounting for plan assets is, in principle, straightforward since the assets are fair valued. However, the PBO is difficult to measure, as it involves payouts decades into the future, with a high degree of uncertainty regarding how much will actually be owed (due to life expectancy, retirement salary levels, etc.). On top of this uncertainly there is ambiguity about how to discount the expected future cash outlays to determine their present value. Though the final payments are not entirely known, in theory the obligations are fixed by criteria established in the plan. Accordingly, the appropriate discount rate is the riskless rate.

Unfortunately, the Financial Accounting Standards Board (FASB) has never specified how firms should select an appropriate discount rate. As a result there is significant variation across firms, even though there is absolutely no reason that the discount rate should differ across companies. Even firms that claim to use essentially the same methodology show substantial variation in their chosen discount rates.

In our research we have found that companies that use relatively higher discount rates (and thereby report relatively lower PBO values) state that they base their rate on some average of corporate bond yields. Economically this approach makes no sense because the default premiums imbedded in corporate bond yields merely reflect the likelihood that *other* companies will fail to honor their *bond* obligations. The premiums have no effect on how much the reporting firm is obligated to pay its pensioners. Indeed, the use of a risk-adjusted discount rate would only be appropriate if management were concerned about the firm's ability to satisfy the pension obligation.

Needless to say, this distinction is very important in 2008, when default premiums on corporate bonds increased greatly due to the abnormally high (but likely transitory) level of economic uncertainty. As a consequence, many firms raised their pension discount rates in a year when the risk-free interest rate actually fell. This trend substantially reversed itself in 2009, with many companies slashing unsupportable discount-rate assumptions.

### INCOME STATEMENT AND BALANCE-SHEET PRESENTATIONS

The PBO (plan assets) meets the standard accounting definition for a liability (asset). However, these accounts are not reported directly on the balance sheet. Instead, the PBO and plan assets are netted against each other to determine the funding status. If the PBO is larger, there is a funding deficit, which is reflected as a net liability on the balance sheet. If the plan assets are larger, there is a funding

[4] In theory, this amount reflects what the company would owe if the existing plan were curtailed and the present value of all benefits were paid out to employees today.

surplus, which is reported as a net asset on the balance sheet.[5]

The income-statement presentation is more complex because of a variety of smoothing effects meant to limit the year-to-year variability in pension expense. The most prominent smoothing effect is the use of an expected return rather than the actual return to calculate pension income (which is netted against pension expense). Thus, a fund that loses $1 billion on $3 billion in investments during 2008 could still report a net gain of, say, $240 million if it expects the plan's investments to earn 8% over the long term. In theory, fluctuations between actual and expected returns should even out over time. But this will occur only if the company has consistently used a realistic, long-term expected rate of return.

Unfortunately, the FASB also offers little guidance in the selection of an appropriate expected return. Not surprisingly, public companies also vary considerably in the expected rates of return they use. For those firms that chose an unattainably high expected return, economic reality generally catches up with them over time. Ultimately, these firms are likely to be forced to make sizable contributions to offset their growing pension deficit. Their pension losses must also be recognized against net income over time.

Pension losses flow through net income in two ways. First, when pension assets decline in value, the amount of accounting-based "pension income" (i.e., not the real amount of investment income) will decline because the expected *rate* of return is multiplied against a smaller base of assets. Second, if actual pension income deviates too far from what has been recognized in income, the "excess loss" is gradually amortized as additional pension expense under what the FASB refers to as the "corridor approach."

For example, if a firm lost 28% of its plan assets in 2008 (the median loss reported for our sample of publicly traded domestic firms), pension income for 2009 would only be 72% of the amount reported in 2008 (assuming the expected rate remains the same). Furthermore, if the company fails the test required under the corridor approach, additional losses may be amortized to pension expense each quarter. Either one of these mechanisms (or worse yet, both of these mechanisms) could cause a nasty earnings surprise for many firms in 2009 and beyond.

### STATISTICAL EVIDENCE

In our *Issue Commentary* last year, we tested two hypotheses about how companies select the discount rate and the expected rate of return. Our analysis demonstrated that firms with higher true pension deficits were more likely to select high discount rates. Also, firms with especially poor actual returns were more likely to increase their expected returns going forward. Both findings were

[5] This is only true in recent years (since SFAS 158 was promulgated in 2006) and is still not necessarily the case for firm's using international financial reporting standards (IFRS). For various reasons, before SFAS 158, the balance-sheet numbers could be different from the funding deficit/surplus reported in the footnotes. Even now, the real economic deficit could deviate substantially from the balance-sheet liability if the PBO is mismeasured as a result of the many assumptions involved.

statistically and economically significant. These findings are consistent with firms with pension problems strategically choosing assumptions to cover up those problems.

The results of our tests lent credence to our focus on firms with large pension deficiencies and unusual assumptions. The firms we've selected for coverage are, statistically speaking, likely to have chosen relatively extreme assumptions in order to distort their financial results. This does not necessarily imply that the firms we highlight in our report have, in fact, manipulated these key assumptions to cosmetically enhance their financial results. In some—or even all—of the cases we highlight, the results could be due to random chance. (That's not terribly likely ... but it is theoretically possible.)

**We Set Companies on an Equal Footing and See Who is Lacking**

### WE APPLY A SYSTEMATIC APPROACH TO A LARGE SET OF FIRMS

Our goal is to eliminate differences in pension accounting caused by firms' accounting assumptions, as there is little reason to expect that the assumptions should vary across companies and much reason (see above) to expect that differences that do exist are driven in part by opportunism. With a consistent methodology for pension analysis we hope to estimate the following:

- How large the real economic deficits in companies' pensions are. This affects the likely cash-flow consequences in future years.
- How much of the real deficits are not shown on the balance sheet as liabilities. This is the amount that investors are probably unaware of.
- How much the sustainable long-term pension expense is likely to be, relative to 2009 expense as reported. This is clearly critical for long-term valuation.
- How much as-reported pension expenses in 2010 and beyond are likely to exceed 2009 expense. This could cause significant earnings surprises.

### STEP 1: SELECTION OF COMPARABLE FIRMS

First, we need to establish a set of firms to compare. Our goal is to have as large a set as possible while having complete detailed pension data and fully comparable companies.

We first began by eliminating all companies below $800 million in market capitalization from our study. We further removed all ADRs from consideration and only included companies that closed their fiscal year between 11/15/09 and 03/01/10. To focus our study further, we considered only companies with active defined-benefit pension plans (although a couple of exceptions were made in the current analysis).

Our primary source of pension plan data was Capital IQ. However, for companies that maintained multiple plans with multiple assumptions, had plans in multiple geographies with multiple assumptions, or had disclosed discount-rate and expected return-rate assumptions as a range, data was hand-collected from 10K statements.

For data-testing purposes, discount and expected-return-rate assumptions were averaged (if companies maintained multiple plans) using the PBO and plan assets, respectively, as weights. For companies that provided a range of assumed rates, we used the median.

### STEP 2: ESTIMATING THE TRUE ECONOMIC PBO

There are a number of critical assumptions that go into the calculation of the PBO. While salary growth, for example, is important, we are not in a position to assess it in a large scale cross-sectional comparison. Other assumptions are not even disclosed but critical to the cash-flow projections behind the PBO figure. The only assumption we can assess is the discount rate. Since the rate is used to adjust for the time value of money in valuing future cash obligations, it should in principle be the same for all firms and should, in fact, equal the long-term risk-free rate. Considering this, we impose a uniform rate of 3.97%, which is an average of recent rates on 30-year Treasury bonds. Since the average pension assumes a much higher rate of 5.77%, our estimate of the true economic PBO is generally much higher than the figure reported by the firm. The key point, however, is that we use a method that puts all companies on an equal basis and does not reward firms for choosing an abnormally high discount rate.

Since we do not know the year-by-year cash-flow projections that are being discounted to derive the PBO, we adjust for the difference in discount rate indirectly. We apply a method first used in our 06/12/09 *Alert* on Michelin, whereby we assume a pattern of future obligations starting at the current level of cash outflows, growing at an unknown rate for 20 years, flattening out for 10 years, and then declining to nothing over 50 years. The exact pattern we assume has minimal effects on our estimates. Since we know the firm's reported PBO and discount rate, we can calibrate the cash-flow projections to match these numbers by setting the growth rate appropriately. We can then substitute the uniform discount rate and estimate the PBO with that calibrated growth number. This adjusted PBO allows a largely discretion-neutral metric for comparing firms.

### STEP 3: SUSTAINABLE LONG-TERM PENSION BENEFIT EXPENSE

While the PBO assumptions (discount rate) are major drivers of balance-sheet presentation, the discount rate has only a modest impact on the income statement in the short term. The expected return has a direct impact on the pension-expense calculation. Unlike last year, after the big market plunge, short-run earnings are not likely to show adverse earnings surprises in 2010 at many firms. Instead, in this report we focus primarily on potential longer-term earnings effects of pension assumptions that may be misaligned with economic reality.

To assess the longer-run earnings effects, we construct a measure of sustainable pension expense by utilizing our assumptions, which are uniform across companies. This includes the discount rate as discussed above, as well as the expected return, which we believe should be 6% for the typical pension asset allocation (the median is 8%, which strikes us as optimistic).

To estimate the sustainable mid-term pension expense, the assumptions used to calculate the 2009 pension expense were held constant except for expected return and expected interest costs. Interest costs were calculated based upon our adjusted PBO multiplied by our discount-rate assumption. Expected returns were assumed to be 6.00% multiplied by plan-asset values at the close of the most recent fiscal year.

**Highlighting Seven Firms with Severe Pension Deficiencies**

## SELECTION OF FIRMS THAT MAY BE MISPRICED BECAUSE OF A FAILURE OF THE MARKET TO REFLECT THEIR TRUE ECONOMIC PENSION OBLIGATION

Using the data developed in the prior section, we examine firms that have especially large pension deficiencies, abnormally high assumptions (and unusual increases in them), and are likely to see material increases in their pension expense and cash outflows this year and in the years to come. These are firms that we feel investors should be wary of, as the pension problems could be a devastating time bomb, especially if financial markets continue to be weak in the next few years. For many of these companies, their deficits are so vast that even a strong bull market might not be enough to rescue them.

While there may be a perception that, after the 2008 crash, all companies had fairly significant pension problems, this is not entirely true. First, not all firms have large defined-benefit plans, and those with defined contribution plans are fine (though their employees may not be). Those with small defined-benefit plans or less-optimistic assumptions are also unlikely to be facing severe deficiencies—certainly nothing of the magnitude as the companies highlighted below. Likewise, the asset-value recovery in 2009 might seem to have solved much of the pension problems that arose in 2008, but in fact, this recovery was insufficient in magnitude to have mended the gaping deficiencies at several companies, including the firms we focus on in this *Commentary*.

Our analysis consists of two parts. The first part of the analysis provides a summary update of our current view on the nine companies featured in our former *Issue Commentary* (07/07/09). The second part of the analysis introduces seven new companies with outlier pension-accounting assumptions that we believe are likely to imply overvaluation of the firms and may lead to significant financial problems in coming years.

**Continuing Concerns Regarding Formerly Featured Companies**

## FIVE FIRMS MOVED TO NEUTRAL, FOUR FIRMS REMAIN NEGATIVE

In our former *Issue Commentary*, we featured nine names across a variety of industries in which the company's pension assumptions appeared outsized relative to the total sample. The companies featured include Allegheny Technologies Inc. (ATI) , FMC Corp. (FMC), AES Corp. (AES), Pactiv Corp. (PTV), United Parcel Service Inc., (UPS), J. C. Penney Company Inc. (JCP), Allstate Corp. (ALL), Marsh & McLennan Companies Inc. (MMC), and Citigroup Inc. (C). Over the following six months, those companies underperformed the S&P 500 by a fairly robust average of 4.7% (or 9.6% annualized).[6]

After reviewing current discount rate and assumed rates of returned applied to the accounting for pension for 2009, our view has moved to Neutral on ATI, FMC, JCP, ALL, and C. The move to Neutral was largely driven by an improvement in discount-rate ranking, assumed rate-of-return ranking, a lower level of adjusted funding deficit relative to year-end assets, or a combination of these factors. We would note that a number of companies significantly reduced their discount-rate assumptions, in particular JCP (from 6.95% to 5.90%) and FMC (from 7.00% to 5.90%).

We continue to have a Negative view toward the assumptions used by AES, PTV, UPS, and MMC. While PTV significantly reduced its discount rate (from 6.74% to 5.75%), the company continued to utilize one of the highest assumed rates of return on plan assets, which we believe is significantly distorting the company's sustainable pension expense.[7] AES continued to rank at the top of our survey, mainly as result of the company's high discount rates and assumed rates of return being applied to foreign liabilities. For the companies we continue to have a Negative view on, we would continue to expect that the sustainable pension expense is significantly higher than as-presented expenses and that the true size of the economic liabilities to the companies are much higher than presented.

(See table, **Summary Review of Formerly Featured Companies**, *next page*)

[6] We did not specify a time horizon for the firms in that *Commentary*, but the nature of pension accounting is likely to be medium term, so six months seems reasonable. We could not choose a longer period for analysis since one of the nine companies (Citigroup) was featured as a positive in an *Alert* published shortly after the six-month period (on 01/21/10) based on other earnings quality issues that offset the pension concerns we had.

[7] Gradient is currently actively covering PTV. Please see our 04/09/10 *Alert* and 04/23/10 *Research Note.*

### Table 1: Summary Review of Formerly Featured Companies

| Ticker | Current View | Discount Rate | Percentile Rank | Assumed Rate of Return | Percentile Rank | Adjusted Funding Deficit/ Year-End Total Assets |
|---|---|---|---|---|---|---|
| ATI | NEUTRAL | 6.20% | 91st | 8.75% | 94th | 20.8% |
| FMC | NEUTRAL | 5.90% | 58th | 8.50% | 80th | 24.3% |
| AES | NEGATIVE | 10.09% | 100th | 11.64% | 100th | 26.3% |
| PTV | NEGATIVE | 5.75% | 35th | 9.00% | 99th | 53.8% |
| UPS | NEGATIVE | 6.56% | 98th | 8.90% | 98th | 47.6% |
| JCP | NEUTRAL | 5.90% | 58th | 8.40% | 80th | 15.5% |
| ALL | NEUTRAL | 6.25% | 92nd | 8.50% | 80th | 2.5% |
| MMC | NEGATIVE | 6.02% | 82nd | 8.10% | 67th | 35.9% |
| C | NEUTRAL | 8.29% | 100th | 7.75% | 41st | 0.8% |

### Table 2: Summary Review of Currently Featured Companies

| Ticker | Current View | Discount Rate | Percentile Rank | Assumed Rate of Return | Percentile Rank | Adjusted Funding Deficit/ Year-End Total Assets |
|---|---|---|---|---|---|---|
| AMR | NEGATIVE | 6.10% | 85th | 8.75% | 94th | 40.7% |
| EK | NEGATIVE | 5.61% | 22nd | 8.07% | 66th | 38.7% |
| GT | NEGATIVE | 5.73% | 33rd | 7.76% | 43rd | 36.2% |
| ITT | NEGATIVE | 5.98% | 70th | 8.87% | 98th | 31.3% |
| LMT | NEGATIVE | 5.88% | 55th | 8.50% | 80th | 71.2% |
| M | NEGATIVE | 5.65% | 26h | 8.75% | 94th | 12.4% |
| NYT | NEGATIVE | 6.30% | 94th | 8.75% | 94th | 54.6% |

**AMR Corp.**
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| | |
|---|---|
| INDUSTRY | *Major Airlines* |
| PRICE | *$7.10 (07/14/10)* |
| MARKET CAP | *2.36 billion* |
| ENT. VALUE | *9.39 billion* |
| P-E RATIO | *NA* |
| EV/REVENUE | *0.47* |
| DEBT/EBITDA | *33.07* |
| SHORT INTEREST | *9.8%* |
| DAYS TO COVER | *2.1* |
| VIEW | NEG |

**Company description:** AMR Corp., (AMR) operates as a scheduled passenger airline in the United States.

**PBO appears significantly understated as result of outsized discount rate assumption:** As of 12/31/09, AMR's PBO was $12.0 billion. AMR's PBO measurement utilized a 6.10% discount rate. While down from 6.50% in 2008, the utilized discount rate to measure the company's year-end PBO ranked in the 85th percentile of all companies surveyed. After adjusting for what we view as a more realistic discount rate, we believe that the economic value of AMR's PBO may be closer to $17.4 billion, or 45% higher than reported.

**Adjusted funding shortfall represents a material portion of current market capitalization and total assets:** During 2009, AMR's pension assets increased $928 million or 13.8%. However, the gains during 2009 did not offset the $1.66 billion loss (or -18.2%) recorded during 2008. After the firm made contributions of $10 million and paid benefits of $601 million, plan assets stood at $7.05 billion at the end of 2009, resulting in a $4.95 billion shortfall on an as-presented basis. After adjusting the PBO to reflect a lower discount rate, the funding shortfall increases to $10.3 billion or 40.7% of total assets as of 12/31/09 and 459% of the company's current market capitalization.

**High expected long-run rate of return causing a significant distortion of sustainable pension expense:** During 2009, AMR reported a pension expense of $637 million, up materially from $341 million during 2009. The surge of pension expense was driven by a lower asset base to drive the company's expected return on plan assets, as well as elevated interest costs and the amortization of previously deferred actuarial losses recorded in accumulated other comprehensive income. However, we believe that AMR's pension expense remains significantly understated as a result of the company's outsized return-rate assumption of 8.75% of assets—which ranks within the 94th percentile of all companies surveyed.

**Sustainable expense may prove markedly higher than company's guidance for 2010 pension expense:** For 2010, management has estimated a pension expense of $670 million. However, after adjusting for a higher interest expense (based on the adjusted PBO times 3.97%), a lower expected return on plan assets (6%), carrying forward service expense from 2009 (of $333 million), the expected amortization of prior plan losses ($154 million), and the amortization of prior service fees ($19 million), we believe that the company's sustainable pension expense may be closer to $773 million, or 15% higher than anticipated by management. With approximately $3.0 billion in net actuarial losses recorded in other comprehensive income, we believe that the company's amortization of prior-period losses will remain significant going forward.

# Issue Commentary

**Eastman Kodak Co.**

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| | |
|---|---|
| INDUSTRY | *Photographic Equipment & Supplies* |
| PRICE | *$4.71 (07/14/10)* |
| MARKET CAP | *1.27 billion* |
| ENT. VALUE | *1.06 billion* |
| P-E RATIO | *4.89* |
| EV/REVENUE | *0.13* |
| DEBT/EBITDA | *0.00* |
| SHORT INTEREST | *23.2%* |
| DAYS TO COVER | *7.7* |
| VIEW | NEG |

**Company description:** Eastman Kodak Co. (EK) provides imaging technology products and services to the photographic and graphic communications markets worldwide.

**Lowered discount rate brings EK's PBO closer to reality:** The magnitude of EK's as-presented pension funding deficit ranked among the highest in our sample relative to total assets and market capitalization. Making matters more concerning, after adjusting the company's PBO based on what we view as a more realistic discount-rate assumption, it appears that the company is in the second worst deficit position on a relative-to-market-capitalization basis. At the end of 2009, EK's combined domestic and foreign PBO was $8.4 billion based on a weighted discount rate of 5.61%. EK's weighted discount rate is based on a 5.75% assumption for U.S. plans and 5.41% for non-U.S. plans. This marks a significant improvement from the 7.0% assumption for U.S. and 5.93% for non-U.S plans used during 2008. After adjusting for what we believe is a more reasonable discount-rate assumption, EK's adjusted PBO increases by 22% to $10.3 billion.

**Size of adjusted deficit represents a material portion of market capitalization, total assets:** On an as-presented basis, EK's plan is underfunded by $1.12 billion, equivalent to 96.3% of the company's current market capitalization and 14.6% of total assets as of the end of 2009. After adjusting for a higher PBO, the deficit widens to $2.98 billion, equivalent to 255% of the company's current market cap and 38.7% of total assets. The size of the adjusted deficit relative to both total assets and market capitalization ranked among the highest in our study.

**Reporting of pension income while significant losses are stored in AOCI appears incongruent with economic reality:** During 2009, EK reported net pension income of $132 million before the impact of special termination benefits, curtailment gains, and settlement losses. EK's ability to report pension income was primarily the result of a relatively high weighted-average return assumption of 8.07%, ranking in the 66th percentile of all companies examined. Of significant concern, EK recorded $694 million in expected return on plan assets during 2009, while the company's combined assets only returned $444 million, or 6.1% during the year. We find this very troubling given the fact that the company reported a loss of 18.2% in the year prior. In general, we would have expected the company's assets to significantly rebound during 2009 as the overall market rebounded from losses recorded as part of the 2008 financial crisis. EK's cumulative performance is well below that of the typical firm. Going forward, we believe EK's pension expense will be far removed from actual economic reality if the company's plan assets continue to underperform the assumed rate of return utilized in the period pension expense.

**Sustainable pension expense appears materially higher than EK's current reporting level:** If we hold the 2009 service cost constant ($67 million) and add in the expected amortization of prior actuarial losses ($39 million) and prior service costs ($2 million) and further adjust for an interest expense based on our calculation of adjusted PBO ($407.2 million) and adjust this sum for a lower expected return ($437.5 million), we believe EK's sustainable pension expense is closer to $77.8 million—vastly different from the $132 million in net pension income reported during 2009. We believe that EK's reporting of pension income is significantly removed from economic reality given that the company's actuarial losses stored in AOCI are $2.93 billion.

**The Goodyear Tire & Rubber Co.**
1144 E. Market St.
Akron, OH 44316
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www.goodyear.com

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|---|---|
| INDUSTRY | *Rubber & Plastics* |
| PRICE | *$11.49 (07/14/10)* |
| MARKET CAP | *2.79 billion* |
| ENT. VALUE | *5.60 billion* |
| P-E RATIO | *NA* |
| EV/REVENUE | *0.33* |
| DEBT/EBITDA | *2.14* |
| SHORT INTEREST | *4.2%* |
| DAYS TO COVER | *1.8* |
| VIEW | NEG |

**Company description:** The Goodyear Tire & Rubber Co. (GT) engages in the development, manufacture, distribution, and sale of tires and related products and services worldwide.

**Note:** While the company's domestic plan has been frozen, the company continues to incur a service expense associated with employees still accruing benefits due to prior participation in the fund. Furthermore, the company's non-U.S. pension obligations remain open. Given these factors, as well as the significant pension deficit facing the company, we believe it is appropriate to include the company within our study and assess the company's current pension plan status.

**PBO continues to appear materially understated despite decreased discount rate:** During 2009, GT reduced its weighted-average discount rate from 6.44% to 5.73%. Due to the decrease in the company's discount rate, the company's plans experienced an actuarial loss of $749 million. At the end of 2009, GT's combined PBO increased 12.3% to $8.06 billion. However, after adjusting for a normalized discount rate, we believe GT's true economic obligation is closer to $10.56 billion, or 31% higher than the company's as-presented balance.

**Adjusted funding deficit represents a material portion of total assets and market capitalization:** While GT's weighted-average discount rate was relatively low within our sample (43$^{rd}$ percentile) the company's as-presented as well as adjusted funding deficit was among the highest of the companies we examined as a percentage of market capitalization and a percentage of total assets. On an as-presented basis, GT's funding deficit of $2.72 billion represented 18.8% of total assets at the end of 2009 and 112.8% of the company's current market capitalization. On an adjusted basis, GT's funding deficit swells to $5.21 billion or 36.2% of total assets at the end of 2009 and 216.5% of current market capitalization. According to GT's guidance, the company expects to contribute approximately $600 million to its pension funds during 2010. Given the company's sizeable pension deficit (either on an as-presented or adjusted basis) we believe that the company will have to continue to contribute to the fund in order to close the gap between the company's long-term obligations and funds available.

**Sustainable pension expense significantly higher than management's guidance:** While management has guided for a median pension expense of $300 million during 2010, we believe that the company's sustainable pension expense may be 21% higher, or closer to $362 million. Our estimate of sustainable expense reduces the company's expected return on plan assets to $320.6 million based on a 6% return (versus the company's weighted average of 7.76%) and recognizes an interest cost of $418.6 million based on the adjusted PBO and lower interest rate, along with a $60 million service charge for the year. Our estimate also includes $171 million of amortization of previous actuarial losses and $33 million of amortization of prior service costs, as disclosed in the company's 2009 10K. With $3.41 billion in combined prior service costs and net actuarial losses recorded in accumulated other comprehensive income, we anticipate that the company will be recognizing a high level of amortizable losses going forward.

**ITT Corp.**
1133 Westchester Ave.
White Plains, NY 10604
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|---|---|
| INDUSTRY | *Diversified Machinery* |
| PRICE | *$47.23 (07/14/10)* |
| MARKET CAP | *8.67 billion* |
| ENT. VALUE | *9.39 billion* |
| P-E RATIO | *14.37* |
| EV/REVENUE | *0.86* |
| DEBT/EBITDA | *0.46* |
| SHORT INTEREST | *1.8%* |
| DAYS TO COVER | *1.6* |
| VIEW | NEG |

**Company description:** ITT Corp. designs, manufactures, and sells a range of engineered products, and provides related services worldwide.

**Adjusted PBO is materially higher than as-presented PBO:** ITT's PBO at the end of 2009 totaled $5.70 billion, up from $5.32 billion at the end of 2008. During 2009 the company experienced a $286.9 million actuarial loss as result of decreasing its discount rate to 5.98% from 6.24% a year prior. While the decrease of the discount rate is a positive development, ITT's discount rate ranked in the 70th percentile among all companies examined in this analysis. After adjusting for a more defensible discount rate, the company's PBO increased 37% to $7.79 billion.

**Material funding deficit may be a drag on cash flows going forward:** At the end of 2009, ITT had $4.31 billion in assets supporting its PBO, leading to an as-presented deficit of $1.39 billion—equivalent to 12.5% of total assets at the end of 2009 and 16.9% of the company's current market capitalization. After adjusting for a higher PBO based on a lower discount-rate assumption, the deficit widens to $3.49 billion or 31.3% of total assets at the end of 2009 and 42.3% of current market capitalization.

**Evidence of outsized expected return assumption versus disclosures:** During 2009, ITT recorded an expected return on plan assets of $432.9 million. Based on beginning-of-the-year plan assets of $3.61 billion, this would suggest the company utilized an expected return assumption of 12.0% to calculate periodic benefit expense—significantly above the company's stated assumption of 8.87%. Of further concern, the company's return assumption ranks within the 98th percentile of all companies examined in our study. We believe that the outsized return assumption utilized in 2009 unsustainably reduced the company's periodic benefit expense during the year. Aside from the troubling numbers themselves, the fact that ITT's disclosed assumptions match its actual expected return so poorly raises significant concerns for us. Minor variations are to be expected, but this is well outside the norm.

**Sustainable pension expense significantly above prior period expense recognition:** During 2009, ITT recognized a net periodic benefit cost of $47.2 million. Going forward, we believe that ITT's sustainable expense will prove to be significantly higher than the costs recorded in 2009. After adjusting the assumed rate of return to 6% (or $258.5 million), utilizing an interest expense based on the adjusted PBO ($309.1 million), and carrying forward the service expense of $98.7 million recorded in 2009 as well as the anticipated amortization of $80.9 million in prior actuarial losses and $33 million of prior service costs, we believe the company's sustainable pension expense is closer to $234 million—5.0 times the expense recognized in 2009. It is worth noting that the company has $2.03 billion of prior-period actuarial losses to bring to the income statement from AOCI, suggesting that the high level of amortizable actuarial losses is likely to persist into the future.

**Lockheed Martin Corp.**
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Bethesda, MD 20817
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|---|---|
| INDUSTRY | *Aerospace & Defense* |
| PRICE | *$75.50 (07/14/10)* |
| MARKET CAP | *28.01 billion* |
| ENT. VALUE | *29.79 billion* |
| P-E RATIO | *9.98* |
| EV/REVENUE | *0.66* |
| DEBT/EBITDA | *0.35* |
| SHORT INTEREST | *1.9%* |
| DAYS TO COVER | *2.2* |
| VIEW | NEG |

**Company description:** Lockheed Martin Corp. engages in the research, design, development, manufacture, integration, operation, and sustainment of advanced technology systems and products in the United States and internationally.

**LMT's massive PBO significantly higher after discount-rate adjustment:** LMT maintains one of the largest PBO's in the entire world. Among the companies we sampled, LMT had the sixth-largest PBO outstanding at the end of 2009, representing a total of $33.55 billion of obligations. While the company's discount-rate assumption only ranked in the 55$^{th}$ percentile among all companies surveyed (at 5.875%) the rate was still significantly above our benchmark of 3.97%. By adjusting for the lower discount rate, LMT's adjusted PBO surges 41% to $47.15 billion.

**Magnitude of pension deficit the highest amongst large-capitalization firms:** On an as-presented basis, LMT's funding deficit is the largest among large-capitalization firms on a relative to total assets and market capitalization. LMT's funding deficit exiting 2009 was $11.4 billion, equivalent to 32.5% of total assets at the end of 2009 and 41.2% of current market capitalization. After adjusting for a higher PBO, LMT's pension funding deficit swells to $25.0 billion or 71.2% of total assets at the end of 2009 and 90.4% of current market capitalization.

**Periodic pension expense appears significantly understated as result of outsized expected plan asset return assumption:** In calculating periodic pension expense, LMT states that it utilizes an 8.5% long-term rate of return on assets assumption—ranking in the 80$^{th}$ percentile among all companies analyzed. However, we note that the expected return on plan assets of $2.03 billion that was used to calculated periodic benefit cost during 2009 would imply that the company actually assumed a long-term rate of return of 10.9% based on a starting asset balance of $18.5 billion. This discrepancy is not explained within LMT's financials and raises similar concerns as with ITT.

Regardless, we view the size of the offset to periodic pension expense as unjustifiable and unsustainable. While the company's 20% return on plan assets ($3.64 billion) during 2009 would appear to support a long-term rate-of-return assumption of 8.5%, the gain was less than half of the total loss recorded on plan assets during 2008 of $7.35 billion. After normalizing for a long-term rate of return of 6%, we would expect the offset to pension expense to shrink to $1.33 billion. Applying this assumption to an interest cost based on an adjusted PBO of $1.87 billion, a carry-forward of service costs of $870 million, and the amortization of $595 in prior actuarial losses and $83 million of prior service losses, we would anticipate that LMT's recurring sustainable pension expense is closer to $2.09 billion—far greater than the $1.04 billion reported during 2009. With $11.8 billion in net actuarial losses (along with $457 million in prior service costs) stored in AOCI, we believe that the high recognition of amortizable losses will continue in the near-to-mid-term.

**Macy's Inc.**
7 West Seventh St.
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www.macysinc.com

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|---|---|
| INDUSTRY | *Department Stores* |
| PRICE | *$18.38 (07/14/10)* |
| MARKET CAP | *7.76 billion* |
| ENT. VALUE | *15.00 billion* |
| P-E RATIO | *16.92* |
| EV/REVENUE | *0.63* |
| DEBT/EBITDA | *2.55* |
| SHORT INTEREST | *5.0%* |
| DAYS TO COVER | *1.7* |
| VIEW | NEG |

**Company description:** Macy's Inc., (M) operates department stores and Internet Web sites in the United States.

**Lower discount rate brings PBO closer to reality:** At the end of 2008, M increased its discount rate aggressively from 6.25% to 7.45%. However, during 2009, the company lowered its discount rate significantly to 5.65%. As result of the significantly lower discount rate, the company's PBO experienced a $401 million actuarial loss, which in part drove an increase of the overall PBO from $2.44 billion to $2.88 billion. On a positive note, the company's current discount rate ranks in the 25th percentile relative to all other companies examined in this *Commentary*. However, based on the following analysis, we believe that the economic costs of the company's pension plans may not have been appropriately reflected in the most recent period.

**Adjusted pension deficit a material portion of total assets and market capitalization:** At the end of 2009, M had $1.87 billion of assets supporting the company's pension plans, leading to an as-presented deficit of $1.01 billion or 4.8% of total assets at the end of 2009 and 13.4% of the company's current market capitalization. After adjusting for our assumed lower discount rate, the company's PBO increases to $4.50 billion and the adjusted deficit widens to $2.64 billion or 12.4% of total assets at the end of 2009 and 34.9% of the company's current market capitalization.

**Outsized return assumption appears to have been utilized to calculate periodic benefit cost:** Similar to other companies mentioned in this analysis, it appears that M utilized a return assumption in the computation of the company's net periodic benefit cost that is significantly above the company's stated long-term expected return on assets. Specifically, the company recorded an expected return of $187 million within the calculation of net periodic pension cost. Based on a beginning asset balance of $1.44 billion, this would suggest that the company utilized a 13.0% return assumption during the year, significantly above the company's disclosed expected long-term return on plan assets assumption of 8.75%.

**Outsized return assumption helps to understate periodic benefit expense:** Of further concern, it appears that the company's sustainable pension expense is significantly higher than recorded expense in 2009 as result of M utilizing a materially high assumed rate of return on plan assets. Specifically, the company's assumed rate of return of 8.75% ranks within the 94th percentile of all companies examined in this report. After adjusting for a lower assumed rate of return of 6% ($111.9 million), applying an interest cost based on an adjusted PBO ($178.6 million), carrying forward the service cost of $81 million, and further recognizing $60 million of amortization expense associated with prior actuarial losses as well as a $1.0 million gain associated with prior service credits, we calculate that the company's sustainable pension expense is closer to $206.7 million—materially above the $66.0 million recorded in 2009. Furthermore, the company has $1.19 billion of net actuarial losses recorded in AOCI, suggesting that the elevated level of amortization of prior actuarial losses will sustain into future periods.

**The New York Times Co.**
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| INDUSTRY | *Publishing* |
| PRICE | *$9.59 (07/14/10)* |
| MARKET CAP | *1.40 billion* |
| ENT. VALUE | *2.06 billion* |
| P-E RATIO | *13.32* |
| EV/REVENUE | *0.85* |
| DEBT/EBITDA | *1.73* |
| SHORT INTEREST | *10.1%* |
| DAYS TO COVER | *4.1* |
| VIEW | NEG |

**Company description:** The New York Times Co. (NYT) operates as a diversified media company in the United States.

**Note:** While NYT's qualified defined benefit pension plans were substantially frozen at the end of 2009, the remaining liability and the company's accounting treatment of both the measurement of the PBO and periodic benefit expense appear substantially distorted by the company's high discount rate and expected long-term return assumptions. We note that the company maintains a non-qualified plan that is not funded. At the end of 2009, the unfunded plan represented 12.1% of the company's total outstanding obligations and further represented 30.7% of the as-presented pension funding deficit. Given the magnitude of the company's overall deficit and the outsized assumptions used to calculate benefit expense and obligations, we believe it is appropriate to maintain the company within our sample and analyze the pitfalls of the company's accounting.

**Adjusted PBO significantly above as-presented PBO:** At the end of 2009, NYT's PBO totaled $1.9 billion, consisting of a $1.67 billion obligation for qualified plans that are funded as well as $230.6 million for non-qualified plans that are not funded. Of concern, NYT utilized a discount-rate assumption of 6.30% to measure its obligations at the end of 2009, which ranks in the 94th percentile of all companies analyzed in our study. After adjusting to our lower discount-rate assumption, the company's combined PBO jumps 49% to $2.84 billion.

**Funding deficit and adjusted funding deficit represent a material portion of assets and market capitalization:** At the end of 2009, NYT had $1.15 billion of plan assets, thereby leaving the company with a total funding deficit of $520.3 million for the qualified plans and $750.9 million for all benefit obligations, or 24.3% of total assets at the end of 2009 and 60.0% of the company's current market capitalization. After adjusting for a higher PBO, NYT's funding deficit widens to $2.84 billion or 54.6% of total assets at the end of 2009 and 134.8% of current market capitalization.

**Did an outsized return assumption unsustainably bias periodic pension expense lower?** During 2009, NYT states that it utilized an 8.75% assumed long-term rate of return on plan assets in the calculation of its periodic benefit expense. However, based on a starting balance of $994.8 million of assets, the utilized assumed return assumption of $113.4 million would appear to suggest that the company actually utilized a 11.4% assumed rate of return during the year—significantly above the company's stated rate of return. Worse, the company's stated assumed long-term rate of return of 8.75% ranks within the 94th percentile among all companies in the study.

**Sustainable pension expense much larger than 2009 expense:** Excluding a $54.0 million net curtailment gain recognized in 2009, NYT reported a periodic benefit expense of $55.6 million. However, after lowering the assumed long-term rate of return on plan assets to 6% (resulting in an expected return on plan assets of $69.1 million versus $113.4 million recorded in 2009), annualizing the three-month service cost recognized during Q1 2010 ($12.5 million), adjusting interest cost to reflect the adjusted PBO ($112.6 million), and further applying the assumed amortization of prior actuarial losses of $19 million and $1 million of prior service costs, we believe the company's sustainable pension expense is closer to $76.0 million—36.7% higher than reported during 2009. With $678.8 million in actuarial losses and prior service costs stored in AOCI, we expect a high rate of amortizable losses to be recorded in the near-to-mid-term.