CLAY TOKENS

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Deficiencies in GAAP/IFRS vis-a-vis Uniform Accounting

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Antiquated policies still lead to modern-day headaches

For companies to succeed, they need a strong workforce of employees. Employees are the ones that actually carry out a business' daily operations, and as such no business can stay afloat without the right people.

It should come as no surprise then that companies invest a lot in their workforce. For most businesses, labor represents one of its largest expenses. Companies typically set aside 15% to 30% of revenue towards their payroll budget to ensure they are able to attract and retain the best talent they can.

Historically, in an effort to further compensate employees and reward their loyalty to the business, companies offer pensions that would pay workers a percentage of their salary after retirement. This would incentivize talented employees to stay with their current employer in the long-run.

Pension plans were first introduced in 1875, and gained mass popularity in the 1930s when labor unions pushed employers to offer them. By 1980, approximately 60% of the private sector workforce was a part of a pension plan.

Today, traditional pension plans are far less popular among employers, having been replaced by other types of retirement plans, and now account for just 4% of the private sector. However, traditional pensions can still be found in some industries, especially those where employees are represented by a union.

Pensions have lost relevance in large part due to the financial burden for companies associated with maintaining them compared to alternatives such as a 401(k). The complexity of pensions can lead them to often be more expensive than anticipated. An even larger concern for company CFOs and comptrollers, it leads to uncertainty in how they must manage their cash flows.

This is because there are major differences in how these plans are funded, or in other words, how a company must set aside cash to sustain them. Retirement plans can be broken down into two categories: defined contribution plans, such as a 401(k), and defined benefit plans, such as pensions.

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Defined contribution plans are the simpler of the two. They guarantee the amount of money invested into the plan, not the amount of money that comes out once an employee retires. How much the employee ultimately gets is predominantly based on the returns of the funds.

Defined contribution plans are simpler for companies to manage because the onus falls on the employee to invest. All management needs to concern itself with is matching the investment, when applicable, making it far easier to estimate pension costs.

Defined benefit plans, on the other hand, promise an employee an annuity, or regular income stream, once they retire. Regardless of the underlying returns of the funds, the employee is guaranteed a set amount.

In order to guarantee future payments, management relies on actuaries, professionals trained to assess the financial costs of risks and uncertainty, and a number of assumptions to determine how much needs to be invested into the pension plan today to fund obligations down the line. To estimate annual funding requirements, actuaries need to make assumptions about how long employees will work at the company, their ending salaries, how long employees will live after retirement, and what returns should be expected from investments, among others.

Naturally, this can become incredibly complicated for a company like UPS, with 340,000+ pension-eligible employees, to calculate the correct amount of money it needs to set aside to fund these plans.

Making matters worse, costs associated with maintaining pensions can flow through a company's income statement in different ways, impacting its earnings. This makes it incredibly difficult for investors to understand what part of pensions represent a real operating cost for the business, the cost of employment, and what represents a financing (over/underfunding plan) or investing (return on pension assets) decision that is fueled by non-cash actuarial assumptions.

When adjusting for pension expenses under Uniform Accounting, we need to break out the real operating costs from the rest of the pension accounting noise.

Pension service costs are the costs a company incurs for funding current employees' post-retirement benefits. This represents the cash invested into these plans over an accounting period, and is an operating cost by nature, which can be compared to salary expense.

Other pension costs such as interest costs and plan return on assets, typically represent the increase or decrease in a pension plan's funding status in a given period. In other words, it shows the difference between a company's estimated current pension value and the present value of its estimated future obligations.

As an example, if a pension plan is expected to grow its asset value by 10% during the year, but only grows 5% due to lower returns from investments, the difference is recorded as pension interest expense.

This is not an actual cost that is representative of a company's operations - it is a question of financing and obligations and should be dealt with separately. A firm's operating earnings should not be determined by the result of changing actuarial estimates. What's really important is real cash spent by the business.

So when making Uniform Accounting adjustments, it is important to start by clearing the slate and adding back all pension expenses to a company's earnings. Next, once the operating pension service costs are broken out, those should be subtracted out from the adjusted value.

These adjustments are key in determining a company's true operating earnings. As-reported financial metrics misrepresent the real costs of maintaining a pension for companies and can drastically change investor perceptions of a company's earnings profile.

Take UPS for example. Under as-reported accounting, the company recorded a net income of $11.5 billion in 2022. The company spent $11.4 billion on pension servicing costs alone, but only recognized $9.2 billion in total pension costs as a result of estimate adjustments.

When the necessary adjustments are made by including only servicing costs in earnings and removing other pension costs, investors can realize that the firm's as-reported earnings are overstated by $2.2 billion.

These two adjustments are made to a firm's income statement to more accurately represent UPS' true operating earnings. While the balance sheet and obligation aspects of pensions are an important consideration, investors should be cautious in not lumping all these items together. The Uniform Accounting treatment of the pension balance sheet is worthy of its own discussion and will be covered in future Clay Tokens publications.

The convoluted treatment of pension expenses is just one example of where as-reported metrics distort a company's earnings. This adjustment, in conjunction with over 130 other adjustments made under Uniform Accounting, ensure that financial statement users are given the clearest picture of the operating reality of a company when making an investment decision.