Rating Underfunded Pensions
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What pension funding means for credit ratings; why private equity is pricing health plans; the fate of the R&D tax credit; finding "financial experts"; the Thompson memo debate; short-term places to stash cash; and more.

To the ever-expanding list of pension headaches, add this one: credit ratings.

The Pension Protection Act of 2006, an almost 1,000-page bill that President Bush signed into law in August, sets a funding target of 100 percent for defined-benefit pension plans. It also requires companies to make increasingly large contributions to their pension programs if their balances fall below the required level.

Those potential payments have caught the eye of credit analysts, who are already scrambling to decide how to factor unanticipated cash outlays into corporate credit ratings. A report released by Standard & Poor's states that employers that retain a defined-benefit pension program will be subject to special scrutiny. According to the report, "The implications for [plan] sponsors will vary widely, and be fact- and plan-specific. It is impossible to discern potential trends from information currently available in financial reports."

"If you're a healthy company," says S&P managing director and chief accountant Neri Bukspan, the new rules "may put a little strain on your cash flow." Bukspan doesn't think the requirements will be crippling for any companies. But, he says, "if you're an unhealthy company, they will not help you maintain your rating and in many cases may weaken the rating."

A comparable report from Moody's Investors Service noted that while it does not expect any ratings surprises, the firm "expects to have discussions with our rated issuers to better understand their funding plans."

Credit-rating scrutiny is understandable, considering the sweeping nature of the law. The act changes smoothing of interest rates to two years for both assets and liabilities (down from five and four years, respectively), creating uncertainty regarding the year-to-year cost of funding retirement plans. In addition, the new funding requirements will cause many CFOs to consider "liability-driven" investment strategies, predicts Dale Wallis, CFO of Aerospace Corp., meaning they will opt for more-cautious investments, accepting lower returns in order to avoid unexpected shortfalls.

For companies with significantly underfunded pensions, one option may be to switch to a cash-balance program rather than try to make up the difference under the law's expedited schedule. (Most companies must comply with the provisions relevant to defined-benefit plans by 2008.) The new reform act will give cash-balance plans a legal boost by declaring them permissible under the law, which could short-circuit lawsuits that have challenged the legitimacy of such plans. The law also helps 401(k) sponsors by giving them more leeway to offer investment advice to participants.

Still, the credit-rating issue may be one more reason companies opt to bail out of the pension business altogether. "Funding reform will expose the inherent volatility of

defined-benefit plans," says Rohit Mathur, one of the authors of the Moody's report. — Rob Garver

Dropping Out

Companies that have scaled back their DB plans since pension legislation passed in August.

1. DuPont

DB plan closed to new employees on January 1; pension contribution reduced to one-third of current level

2. Tenneco

DB plan frozen as of January 1; company expects to save $11 million annually

3. Blount International

DB plan frozen as of January 1; company expects to save between $16 million and $23 million over next five years

Take It from the Top

Private-equity firms are getting more involved in the health-care game, and not just from the acquisition side. To cut costs, they're buying health-care plans for their portfolio companies.

The Riverside Co., a private-equity firm with three funds totaling $1.3 billion, is rolling out a plan to the majority of its 51 companies. The plan, offered by United Healthcare Services, the first insurer to provide health coverage specifically for private-equity firms, allows Riverside's companies to cut costs by aggregating their employees. Other private-equity firms purchasing health care for their respective portfolio companies include The Carlyle Group and Baird Capital Partners.

The move fits into Riverside's strategy of gaining volume discounts by making some purchases at the firm level. "Some private-equity firms, when they aggregate their portfolio companies, can have almost the same buying power as a GE," says Pat Brady of consultancy Crawford Advisors. Riverside also purchases shipping, travel, and telephony services for the companies it owns.

Purchasing health coverage for a portfolio of companies is much trickier, however. Because the companies are rated independently, the claims history of one company must not affect other companies that are owned by the same private-equity firm. To make sure that doesn't happen, the private-equity firm signs a master contract with the insurer guaranteeing a discount. Each portfolio company then signs a separate contract. This two-tiered structure also makes it easy to add and subtract companies from the plan as they are bought or sold by the firm. The plans allow for some customization by the individual companies. At Riverside, CFOs of portfolio companies sit on a steering committee to offer input on the master plan and exchange ideas about plan design.

Pamela Hendrickson, chief operating officer at Riverside, says some companies will remain on independent plans, which will enable Riverside to compare the savings it has been promised from aggregating the health-care purchase. "It keeps [the insurers] honest," she says. — Joseph McCafferty

Politics and the R&D Credit

Lobbyists representing American industry are keeping busy this fall. Representatives from a variety of technology and manufacturing associations are pushing to convince senators to extend the expired Research & Experimentation Tax Credit, also known as the R&D credit. On July 31, the House voted in favor of extending the credit for two years, retroactive to January 1, 2006, but the Senate adjourned on August 4 without passing a bill that included the credit's extension. Believing that the extension was so popular that it could help sway

legislators on other matters, House Ways and Means Committee chairman Bill Thomas (R-Calif.) and Senate Majority Leader Bill Frist (R-Tenn.) attached it to a bill to reduce estate taxes and raise the minimum wage. The bill failed to get the support of Democrats, who oppose the estate-tax reduction.

Although the credit is without controversy, says Clint Stretch, managing principal, tax policy, for Deloitte Tax LLP, it's had a rocky history. Congress has allowed it to expire a dozen times since it was established in 1981, most recently on December 31, 2005. Although Congress has never extended it for more than five years at a time, legislators have always reinstated it retroactively (with a single exception).

The tax credit is worth approximately $7 billion a year to the 16,000 American companies that qualify for it. Rockwell Collins, a $3.8 billion defense contractor, expects to spend about $725 million this year on research and development. The company will see its 2006 effective tax rate increase 1 to 2 percent (or about 2 cents per share) if the credit is not extended retroactively.

The failure to extend the credit has infuriated the bill's backers, who warn that it could drive R&D spending overseas. "At least 10 competitor nations offer more-generous and permanent R&D incentives," says Monica McGuire of the National Association of Manufacturers. According to the R&D Credit Coalition, in 2003 U.S. firms invested $22.3 billion in R&D conducted abroad.

In August, Deloitte's Stretch gave the credit only a 25 percent chance of passing before the November elections. "There's a very good chance that it will pass after the elections and before the first of the year," he says. "But there's some chance they won't get around to passing it until next year. And that has everything to do with politics and nothing to do with substance." — Elaine Appleton Grant

Wanted: Finance Experience

Despite the Sarbanes-Oxley requirement that audit committees have at least one member who qualifies as a "financial expert," many are still headed by an individual with no experience as a CFO or in public accounting, even at the largest firms (see "Can You Spot the Finance Expert?" CFO, September 2005). According to a Crist Associates survey, just 27 percent of audit-committee chairs at Fortune 500 companies have CFO experience, and only 11 percent have spent any significant time at one of the Big Four accounting firms. Almost 57 percent are current or former CEOs, says Peter Crist, founder of the executive-recruiting firm. However, he adds, that number is actually an improvement over the past, when most audit committees were headed by current or retired CEOs. "There is a dramatic change under way," says Crist. "In two to four years, the numbers will be much larger." — J.McC.

Two Steps over the Line?

Corporations have long complained about the methods federal prosecutors use to gain cooperation in white-collar investigations. Now those complaints have been voiced both on the federal bench and in Congress.

In September, a Senate Judiciary Committee held hearings on certain provisions of the Department of Justice's Thompson memo, a 2003 document that set forth guidelines for weighing whether or not to indict a company. A number of witnesses, including Chamber of Commerce president Thomas Donohue and former U.S. Attorney General Edwin Meese, complained that certain tactics used infringe on constitutional rights.

The hearings came less than two months after the second ruling by U.S. District Court judge Lewis A. Kaplan that tactics used in a case involving KPMG were unconstitutional. In the first, Kaplan accused federal attorneys of overstepping their bounds by pressuring

KPMG to cut off payment of attorneys' fees for former partners under investigation. Then, the judge ruled that prosecutors unfairly pressured executives to waive their Fifth Amendment right against self-incrimination — a decision cheered by defense attorneys.
"The rulings help restore some of the balance between government's duty to prosecute crimes and the right of individuals to defend themselves," says Sanford Saunders, an attorney at Greenberg Traurig.
The rulings don't necessarily mean that prosecutors will change course, however. In a July interview with CFO, U.S. Deputy Attorney General Paul McNulty maintained that the Thompson memo was still departmental policy. "We disagreed with the court's decision, and we've been dealing with that case," he said. Then, at the congressional hearings, McNulty added that the government would give "new guidance if, and that's the key here, if something should be identified that would improve the process."
Yet Michael Kendall, a defense attorney at McDermott Will & Emery, thinks the June Kaplan decision could force the government's hand. "It is so powerfully written and reasoned that I expect it to be a powerful precedent," he says. — J.McC.

Ticker Symbols with Pizzazz
In August, Harley-Davidson changed its ticker symbol from HDI to HOG, the nickname for its motorcycles. "The new ticker symbol captures the spirit of what Harley-Davidson is all about — the fun of riding motorcycles," said CFO Tom Bergmann in a statement on the change.
But will it lure more investors? Not likely, says Bob Leahy of the Financial Relations Board, an investor-relations firm. "It may appeal to the retail community, but it will absolutely have no impact on valuation," he says. And using a symbol that is not an abbreviation of the company name can make it hard to find on an alphabetical list, he adds.
Nevertheless, a spokesperson for the New York Stock Exchange says more companies are choosing tickers that reflect their products or brand image. "They're easier to remember and can reinforce what a company stands for," he says.
See if you can match these ticker symbols with the companies they represent.
1) BID A) Brinker International
2) DNA B) Nicor
3) EAT C) Gibraltar Industries
4) FUN D) Sotheby's Holdings
5) GAS E) The Boston Beer Co.
6) LUV F) MarineMax
7) MTN G) Southwest Airlines
8) RIG H) Genentech
9) ROCK I) Vail Resorts
10) SAM J) Steinway Musical Instruments
11) HZO K) Cedar Fair
12) LVB L) Transocean

For the answer key, click here.

Where to Stash the Cash
With companies carrying an increasingly large amount of cash on their balance sheets, some are looking for a more diverse mix of short-term investments than the traditional troika of money funds, bank deposits, and commercial paper.
In fact, a recent survey by the Association for Financial Professionals found that despite written guidelines that allow most corporate treasurers to invest in seven or eight different

vehicles, the majority of firms hold only two or three kinds of short-term investments. "Organizations are not necessarily taking full advantage of the opportunities to generate returns from their cash balances," the AFP warned.

With excess cash, a number of companies are considering transferring some holdings to higher-yield vehicles, such as cash-plus funds or auction-rate securities. "Maybe a different philosophy needs to come into play regarding how companies manage their money if they want to hold it for more than 30 or 60 days," said Sean Locke, director of treasury operations for Aviva Life Insurance. "They might want to start looking for vehicles that offer better returns." According to the AFP, companies that use cash-plus funds generally expect an increased return of more than eight basis points over money markets.

Still, some treasurers say increased diversification of short-term holdings isn't always worth the extra time and effort to manage them. Christy Wright, director of finance and treasury for Ebsco Industries, believes two or three vehicles are "very reasonable" for diversification. "It's more difficult to manage seven different products for short-term cash," she says.

"This is temporary parking for these funds," agrees Ken Parkinson, managing director of Treasury Information Services. "For the most part, you look for an acceptable rate of return and for convenience."

Companies can also diversify cash holdings within money-market funds. Brandon Semilof, a vice president at The Reserve, which manages about $47 billion in cash for hundreds of companies, says it's not important how many different investment categories a company uses. "A firm should worry less about the broad categories into which its cash holdings fall and more about how those holdings are invested within each category," he says. — R.G.

In Case of Emergency

When Tropical Storm Ernesto hit Florida in August, Bill Franklin, manager of travel for Mitretek Systems, was busy tracking how many of the company's employees were in its path. With the help of an interactive database, Franklin could see their location and send them a group E-mail alert if necessary.

With recent terror threats and nasty storms putting kinks in travel plans, companies are increasingly looking to travel-contingency programs. The plans allow companies to track the position of their traveling employees and provide emergency services in response to events such as natural disasters, terrorist threats, and airline strikes. In a worst-case scenario, the programs provide rescue services to get employees out of harm's way. "With all of the violence, Asian flu concerns, and weather threats around the world, we need to make sure that our travelers are not in trouble," says Franklin.

The emergency programs are a fairly recent offering from travel-management companies such as Omega World Travel, Adelman Travel Group, and American Express Business Travel. Some provide real-time personnel tracking via GPS signals to devices issued to employees, as well as 24-hour assistance from travel agents. The most robust plans include the ability to evacuate employees by airlift, and emergency health-care coverage.

Katharine Johnston, CFO of AlphaTrade, is considering plans that offer traveler tracking, evacuation help, and health services for all of the firm's travel destinations. "We want to do whatever we can to help our employees stay safe," she says. Most providers require an annual fee and then bill for any services beyond what the basic membership includes. — Laura DeMars

Deficit Retention Disorder?

At the end of last month, the federal government played its own version of "pretend you're not home when bill collectors call." For nine days, from September 22 to 30, the

government put a hold on Medicare payments to health-care providers. The payments resumed this month, with no interest or penalties added. Why? Because October is the start of the 2007 fiscal year.
Finance executives will recognize the blackout as a game of "shift the expenses." The payment holiday is a simple accounting gimmick to lower the federal deficit, or to at least appear to lower it. The hold shifted $5.2 billion in expenses into the 2007 fiscal year.
Who's behind the charade? Congress. It legislated the hold as part of the Deficit Reduction Act, signed into law in February by President Bush.
"Because the federal government is [operating] on a cash basis as opposed to accrual, it can do these types of things," says Charles Mulford, a professor of accounting at Georgia Institute of Technology. "It's deficit reduction through smoke and mirrors."
In mid-August, the Congressional Budget Office revised its estimate of the federal deficit for FY2006 to $260 billion, down from the $371 billion it had forecast in March. President Bush has vowed to cut the deficit in half by the end of his term.
That could be tough. Mulford explains that the government will likely have to conduct the blackout for at least nine days next year — and maybe longer — to make up for the shift. Isn't that how WorldCom got into trouble? — J.McC.

They're Not Pay Pals

You might be able to buy a grilled-cheese sandwich on eBay with what looks like an image of the Virgin Mary seared into it, but don't try to pay for it with Google Checkout. Google's new online-payment option joined a list of about 30 digital-payment services that have been banned by the online-auction giant in favor of eBay's own PayPal.
In July, eBay announced that it would not take the Google service, which allows customers to store bank or credit-card information in an account that can be used to purchase items on various sites. It says Google's system does not meet eBay's rigorous security measures and needs a successful long-term track record before it can be considered again.
Does a rebuke from eBay spell trouble for Google's new endeavor? Not necessarily.
Marwan Forzley, CEO of MODASolutions, an online-payment processor, says there are plenty of other Internet retailers looking to offer multiple payment options to their customers.
Google said in a statement that, while it disagreed with eBay's decision, it would not pursue litigation. And the spat doesn't seem to have caused a permanent rift between the two Internet heavyweights. Just a few weeks later, they unveiled a plan to display Google advertisements on eBay's site. — L.D.

Verbatim

"Boards would be better served if the CFO had a fixed [pay] package and absolutely no incentive [to backdate options]."

— IRS commissioner Mark Everson testifying before the Senate Finance Committee on September 6.

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