

**From:** Janet Pegg  
**Sent:** Monday, January 26, 2009 12:03 PM  
**To:** Janet Pegg  
**Subject:** Janet Pegg - Pension Accounting Insights: Why CAT's 2008 \$3.4 B pension "charge" will drive 2009 pension expense up \$300mm



A few news stories this morning referred to Caterpillar's (CAT) disclosure of a \$3.4 billion pension charge. Pension accounting is one of the most complicated areas of accounting, so we are providing this short explanation of why this charge did not impact CAT's 2008's net income, but will impact future year's earnings, to help our clients better understand other company's upcoming disclosures.

CAT's January 26, 2009 earnings release contains the following paragraph:

Largely driven by a significant decline in pension asset returns, Caterpillar recognized a \$3.4 billion year-end charge to other comprehensive income. This non-operational charge caused our consolidated net worth to drop below the covenant level in our \$6.85 billion revolving credit facility (Credit Facility). Our corporate bank group has consented to Caterpillar's consolidated net worth level. We have no borrowings under this revolving credit facility.

U.S. GAAP has required companies to record the true funded status of their defined benefit plans on their balance sheets since FAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, became effective at year-end 2006. However, smoothing of pension gains and losses in the calculation of pension expense (the income statement charge) is still permitted under FAS 87, *Employer's Accounting for Pensions*. In order to recognize the true funded status on the balance sheet while deferring the income statement recognition of the plan's gains and losses, under FAS 128 the deferred gains and losses are charged to Accumulated Other Comprehensive Income within Shareholders' Equity. **Therefore, CAT's \$3.4 billion of pension losses did not impact their 2008**

**net income.** These gains and losses will be amortized as a component of future period's pension expense (impacting net income) based on the company's accounting policies. Although companies can start recognizing these gains and losses in earnings immediately, FAS 87 permits these gains and losses to be deferred, potentially until they are greater than 10% of the projected benefit obligation or the market-related value of plan assets (a potentially smoothed valuation of the plan assets). The majority of companies choose to wait until the deferred gains or losses exceed this 10% "corridor". Based on the disclosure in CAT's December 31, 2007 Form 10-K it appears CAT begins amortizing the gains and losses immediately. When a company's policies require amortization of the gains and losses, amortization must be based on at least the amount in excess of the 10% corridor, and it should be over no longer than the average remaining service life of active employees. In its earnings release CAT noted that it expects pension and other postretirement benefit expense to increase approximately \$300 million in 2009. We estimate that 2008 defined benefit pension and postretirement benefit expense was approximately \$480 million for CAT.

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