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| The Fine Print: How to Read Those Key Footnotes  |
| A new periodic series will guide you through accounting issues  |

The sudden collapse of Enron (ENE ), until recently the nation's seventh-largest corporation, took investors by surprise. But had the Wall Street analysts, mutual fund managers, journalists, and individual investors who followed the company dug a little deeper, they could have had a heads-up that all was not quite right at the Houston energy giant long before the bad news broke in October. The source of this information? The footnotes companies are required to publish with their financial statements.

Buried in Enron's annual report for 2000, for example, are hints of the hidden debt that pushed the company into bankruptcy in December. A footnote on "preferred stock" indicates that if Enron's share price were to fall below $48.55--which first occurred on June 14--the company would be obliged to issue stock to a partnership called Whitewing Associates. Other footnotes reveal similar arrangements. True, Enron never put a dollar value on its potential obligations, and the footnotes did not divulge the extent of the partnerships. But enough was revealed to suggest that investors were not getting a full view of the company's finances.

As Enron's collapse illustrates, it is vital to look behind the numbers companies release in quarterly and annual financial statements. That's why *BusinessWeek* Investor is launching The Fine Print, a series in which we will periodically examine various sorts of footnotes you'll find in company reports.

Footnotes often list items that can greatly affect the bottom line yet are invisible on the balance sheet, the income statement, and the cash-flow statement. That's because accountants often combine several items into catch-all categories, such as "other income" or "other assets."

Take IBM. Nowhere does Big Blue's 2000 income statement credit its pension fund for boosting earnings by $824 million, or 7% of pretax income. Yet the pension fund's contribution is spelled out in a footnote. Combined with a section of the annual report called "Management's discussion and analysis," the footnotes "give you some powerful information about the story behind the numbers," says Lynn Turner, director of the Center for Quality Financial Reporting at Colorado State University. "If done right, footnotes will also give you some good predictive information with respect to where the company is headed," he adds.

Footnotes do not make for easy reading, however, and the numbers are often difficult to decipher. In addition, there can be a long lag between the publication of earnings and the clarifying footnotes. Why? While companies generally disclose earnings in a press release shortly after the end of each quarter, they have up to 45 days to file quarterly 10-Qs and up to 90 days to release the annual 10-Ks that contain footnotes.

There's no cookie-cutter method to extract what's important from the fine print. The footnote devoted to transactions with related parties was important at Enron, for example, but it's not relevant to every company. And you can't assume that one footnote contains all a company has to say about a topic. To investigate off-balance-sheet financing, for example, you must often read several footnotes, including those that detail topics such as related party transactions, minority interests, and unconsolidated affiliates. "You have to interrelate things," says Bob Olstein, portfolio manager of the Olstein Financial Alert Fund.

Finally, if after reading a set of footnotes you feel more confused than enlightened, steer clear of the stock. As Enron's fall illustrates, companies that aren't straightforward risk seeing investor confidence evaporate at the first sign of trouble.

We are inaugurating The Fine Print series by examining the footnote for pension accounting. This footnote is key because, during the bull market, income from defined-benefit pension plans became a significant source of profits for many companies. Indeed, pretax earnings were lifted by an average of 12% at the nearly one-third of the companies in the Standard & Poor's 500-stock index that reported pension income in fiscal 2000, says Jane Adams, a pension analyst at Credit Suisse First Boston. Of course, if stock market losses persist, this trend will reverse--with falling pension assets eroding many corporate bottom lines.

When a company promises to pay pension benefits to retirees, it takes on an obligation, or liability. Attaching a figure to that obligation is an inexact science that involves estimating employees' longevity and future salary levels, among other things. To convert the pension obligation from future dollars to a current value, accountants "discount" it at an interest rate that assumes the company will settle its obligation by investing in high-quality bonds.

This number isn't on the balance sheet. Instead, it is offset by the value of the pension plan's investments, adjusted to smooth out some stock market volatility. Depending on whether the plan's obligation or adjusted value is greater, the company records a net pension asset or liability.

To find the pension plan's impact on net income, check the pension footnote in the annual report. For Denver-based Qwest Communications International (Q ), the note shows that the plan produced a "net credit"--or addition--to income of $319 million in 2000 (Table 1). Despite this, Qwest lost $81 million that year.

The same table reveals that the biggest contributor to Qwest's pension windfall was $1.068 billion generated by its "expected return on plan assets." Accounting rules permit the use of an expected return because relying on a day-to-day return would cause net income to jump around with the stock market. The bottom half of this table shows that Qwest expects its plan assets to gain 9.4% a year, on average. It increased that rate from an 8.8% projection in 1999. Given the stock market's doldrums, it's a good bet Qwest didn't meet that goal in 2001.

In contrast to Qwest's $1.068 billion expected return, its actual return was a $78 million loss in 2000, following a $2.5 billion gain in 1999 (Table 2). If real returns continue to trail expected returns, Qwest may build up deferred losses to the point where accounting rules require the company to put some red ink on the income statement.

Partially offsetting the $1.068 billion gain generated by "expected returns on plan assets" are two expenses itemized in Table 1, service cost and interest cost. Service cost represents the pension benefits employees earned during 2000. Interest cost is the annual interest cost on the pension obligation--a figure analogous to interest payments on debt.

Check the lower half of Table 1. There you'll find the "weighted average discount rate" used to figure the current value of these expenses, as well as the overall pension liability. When this rate--pegged to interest rates--falls, the pension obligation rises, says Janet Pegg, a Bear Stearns accounting analyst.

The footnote also indicates if a pension fund is over- or underfunded and thus potentially in need of cash infusions. In Qwest's case, the news is good. At the end of 2000, its pension plan was worth $13.6 billion (Table 2). That exceeded the $9.5 billion (Table 3) it promised to deliver in pension benefits by $4.1 billion. (This number appears under "funded status" in Table 4.) Because Qwest's pension fund is amply overfunded, the footnote shows no company contribution to the plan in 2000.

The days of fat pension gains may be over for Qwest. In part because the plan's actual return for 2000 was negative, the deferred gains--technically called "unrecognized net actuarial gains"--stockpiled during the bull market fell from $4.6 billion to $2.9 billion (Table 4).

Deferred gains can arise when actual returns exceed expected returns. Such gains are put into a pot, along with gains and losses from other pension items, such as changes in assumptions about future salaries. If the pot becomes big enough, some of it is required to spill over into net income. In 2000, Qwest recognized $58 million (Table 1) of its deferred gains--technically called "net actuarial gains." But with deferred gains dwindling, less will be available to boost the bottom line in the future, says Pegg. More troublesome, if the plan's assets continue to shrink, so will the expected returns that nearly erased Qwest's red ink in 2000.

It's a good bet that Qwest is not alone. So check the footnotes in those financial statements to find out whether an ugly surprise may be lurking in the form of fading pension incom