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Commentary

BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

Pension Income and Executive Compensation

For several years we have pointed out the anomalous effect of accounting rules that permit gains on pension fund assets to be credited back as pension income on the accounts of corporate sponsors, even though the pension income is an accounting fiction. No cash or assets revert to the company for an ongoing pension plan and the pension assets are generally held in a separate trust fund for the benefit of participants, not as an asset of the corporate sponsor.

As the effect of the recent stock market boom of the 1990's worked its way through the complex pension accounting rules, huge amounts of so-called "pension income" have been allowed to artificially inflate corporate earnings. Although some investment analysts now recognize this situation and adjust reported earnings accordingly, there is what one observer refers to as "an insidious travesty" in the effect this accounting anomaly has on executive compensation awards. Corporate executives typically receive incentive awards based on financial performance as reflected in the company's reported earnings that may include an artificial credit for pension income.

A particular case in point is General Electric Company (GE). The situation at GE has produced action on the part of a large institutional pension fund that is a GE shareholder. This shareowner has notified GE that it intends to submit the following proposal at GE's Annual Meeting on April 24: "Resolved that the stockholders request that the Board of Directors take the steps necessary to adopt a policy that future executive compensation will be determined without regard to any pension fund income, so that the compensation of senior executives will be more closely linked to their performance in managing the business."

The proposed resolution is supported by the following explanatory statement: "Accounting rules require the Company to include gains on the assets in its pension fund in calculations of income, even though no money is transferred to the Company. This distorts the principle of pay for performance because the Company relies on net earnings and earnings growth in determining the compensation of executives. GE reported $1.7 billion in pension income in 2000. According to a recent study by Credit Suisse First Boston (CSFB), this is the second largest amount reported of all companies in the S&P 500. This pension income amounted to 9.4% of GE's reported pre-tax income for the year. While the impact of earnings calculations may vary, GE's top five executives were given cash bonus awards of $23.7 million in 2000. They were given restricted stock units worth $89 million. They were given long-term incentive awards contingent on financial performance over a three-year period, and were paid $58 million pursuant to the contingent awards that were made in 1997. In addition, they were given options with a potentially realizable value of $422 million if future earnings permit GE stock to appreciate at an annual rate of 10 percent over the option term. Executive compensation ought to be based on performance. It should not be distorted by pension income, because that item of income does not represent money the Company has actually received, and does not reflect the operational performance of either the Company or its executives. As BusinessWeek reported on August 13, 2001,when companies are inflating earnings with income from pension assets, their reported results look better than what's really happening with their business. For this reason, a Morgan Stanley Dean Witter report declares that net gains from pension assets do not deserve the same valuation as true operating income. A related concern according to the Wall Street Journal (June 25, 2001) is the possibility that companies can use pension accounting to manage their earnings by changing assumptions to boost the amount of pension income that can be factored into operating income. According to BusinessWeek, companies can not only play around with the expected rate of return on assets but also with the value of the assets themselves. They can also boost pension income at the expense of employees and retirees by reducing anticipated benefits or withholding improved benefits. CSFB identifies several companies that increased their expected rates of return on plan assets in 2000 even though their actual returns on plan assets declined. While such increases may be an appropriate exercise of discretion, the proposed policy would reduce any temptation that senior executives may have to use pension accounting to manage earnings for the purpose of increasing their own compensation."

GE's Board of Directors has recommended a vote against this proposal. In the light of today's concerns over corporate ethics, we might pose a simple question to the GE Board members: Anyone for ethics? Here is an opportunity to do the right thing to help improve the tarnished image of corporate ethics in America. In this age of Enron ethics and Arthur Andersen ethics, support for a vote for ethical behavior would be a welcome gesture from GE's Board. Ultimately, institutional and individual shareowners will insist that all corporations do the right thing on this issue and take action to exclude pension income from executive compensation. Let us hope that enlightened Boards of Directors will take the initiative and jump rather than being pushed on this issue.

Buffin Partners Inc.

P.O. Box 1255
Sparta, NJ 07871
Phone: (973) 579-6371
Fax: (973) 579-7067
Email: k.g.buffin@worldnet.att.net