

June 18, 2003

## Pensions Fall -- Not CEO's Bonus

### Companies Shift Compensation Formulas To Preserve Payouts to Their Top Officers

By **JESSE DRUCKER** and **THEO FRANCIS**  
 Staff Reporters of **THE WALL STREET JOURNAL**

Corporations have been feeling the pinch as ailing pension plans cut into their profits. But several large firms are making sure that one item doesn't suffer: the bonuses paid out to top executives.

For much of the past decade, pensions helped fatten the bottom line at many companies thanks to an accounting quirk, indirectly boosting executive bonuses and incentive compensation, which are typically tied to a company's financial performance.

Now that the up-and-down stock market has made many pension plans a drag, not a boost, on earnings, some companies including **General Electric Co.**, **Delta Air Lines** and **Verizon Communications Inc.** have started removing pension effects from their executive compensation formulas. In some instances, companies are dressing the maneuvers up as corporate-governance reform.

To understand how, consider **AK Steel Holding Corp.**, the country's third-largest publicly traded steel manufacturer. Until recently, the Middletown, Ohio, company's executive bonus plans contained a simple ground rule: If the company doesn't report net income, its executives don't receive bonuses that year.

For several years, the company's pension plans helped drive executive pay higher. Pension plans can boost earnings because, under accounting rules, companies must indirectly record as income some of the investment gains that pension-plan assets earn, a benefit that really took off during the torrid bull stock market of the late 1990s.

AK Steel benefited more than many: In 2000, for example, the company reported total pretax profit of \$212 million -- 22% of which could be traced to its pension. By 2001, however, that changed. The company started recording pension expense, which rose to \$625 million in 2002, contributing to a full-year loss of \$502.4 million.

AK Steel executives didn't need to worry, however, because the terms for receiving bonuses quietly changed, too.

In describing the plan, the company effectively overrode the clause prohibiting payment of long-term

bonuses if the company had no net income, inserting the words "except as otherwise approved by the Compensation Committee," according to a proxy filed with the SEC in April of 2002. The changes became official earlier this year.

In January 2003, two weeks before announcing the full-year loss for 2002, the company amended the terms of its annual bonus plan, so that bonuses would be pegged to net income "excluding special, unusual and extraordinary items." (The company similarly amended its long-term incentive plan.)



**Richard Wardrop**

As a result, bonuses went unharmed by the new pension expense, which AK Steel classified as "unusual." Over the past two years, under the new rules, AK Steel has paid bonuses to its top five executives totaling \$12.2 million, including \$7.7 million to Chief Executive Richard M. Wardrop Jr., according to proxies filed with the SEC.

AK shareholders haven't been quite so fortunate: The company's shares are off 77% during the past two years, well behind its larger rivals U.S. Steel Corp. and Nucor Corp.

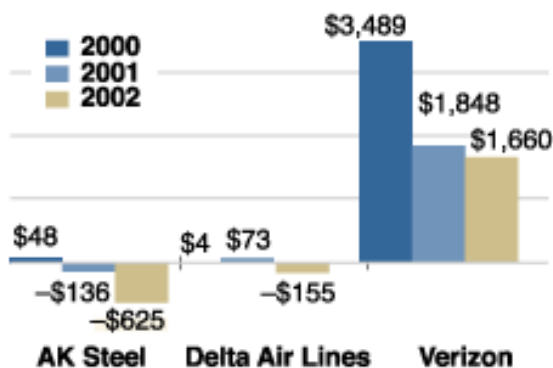
A spokesman for AK Steel declined to discuss the company's moves, including how much the bonuses would have been reduced if pension expense had been taken into account. Compensation consultants say it is nearly impossible to determine that from company filings.

"The proxy statement speaks for itself," said Alan H. McCoy, a company spokesman.

But corporate governance experts say this phenomenon underscores how, at many companies, bonuses are becoming an entitlement, regardless of company performance. "This pattern where pension surpluses are included for bonuses but pension expenses are excluded just underscores how these incentive programs can be manipulated in order to maximize payouts," said Carol Bowie, director of governance research at the Investor Responsibility Research Center, a Washington research and advisory firm for institutional investors.

## PENSION BENEFITS

For years, pension plans have helped the bottom line—and executive paychecks—at many companies. Now that pension income is falling, some companies have begun excluding the figures from executive-compensation calculations. Pension income and expense, in millions.



Source: Company filings

Some companies are cloaking similar moves in the guise of good corporate governance.

For years, shareholder activists have asked companies to de-link executive pay from the pensions, to reduce incentives to cut benefits: reduced benefits can lead to greater pension overfunding and thus pump up company income.

This year, a number of companies, including GE and Delta, decided to voluntarily exclude pension effects.

However, shareholders may not recognize how executives can benefit from this change of heart. For example, this year the compensation committee of Delta's board decided to begin excluding pension results from executive bonus calculations. Good timing: although the company recorded pension income of \$73 million in 2001, it recorded pension expense of \$155 million last year.

A spokesman for Delta says neither pension income nor expense has been a significant factor in company performance or bonus payments in recent years. Moreover, the board will decide each year whether to include pension income or expense for compensation calculations.

Companies shifting from pension income to pension expense could be particularly receptive to excising pension effects from results, "as long as they could change their minds again if things start to go the other way again," says Jack Ciesielski, editor of Analyst's Accounting Observer.

Indeed, even if a company is still recording pension income, the move to exclude pensions from executive bonus calculations could protect the executives from future declines.

Verizon, for example, said its pension could contribute as little as three cents to its earnings per share this year, down from 35 cents in 2002. If that trend continues, the company could begin recording pension expense in 2004. Whatever happens, executive pay will be unaffected.

C. William Jones, the executive director of the Association of BellTel Retirees, who sponsored the original Verizon shareholder proposal to exclude pension effects, said he hadn't thought of the unintended consequences of the new policy, but didn't really care. "Regardless of the outcome, it's good we got them to change it," he said. "It's good corporate governance....And if for some reason there's a turn of events that helps someone, fine. It still makes sense."

A Verizon spokesman said executives wouldn't really be affected by the compensation change, because compensation committee members already discounted pension income. "Our executives have always been compensated based on operational performance and strategic factors and not compensated on losses or gains in the pension fund," he said. The change "codified what was already being done in practice."

GE expects to record about \$1 billion in pension income this year, down from \$1.5 billion the company recorded before taxes in 2002. That could have lowered the chances of a bonus payout before GE began excluding pension effects, because the company's executive long-term incentive plan bases awards in part on net-income growth, says spokesman David Frail. He said, however, that net income makes up just one of several factors in the company's executive incentive plans. GE says it began excluding pension effects at the request of shareholders and its unions.

**Write to** Jesse Drucker at [jesse.drucker@wsj.com](mailto:jesse.drucker@wsj.com)<sup>1</sup> and Theo Francis at [theo.francis@wsj.com](mailto:theo.francis@wsj.com)<sup>2</sup>

**URL for this article:**

<http://online.wsj.com/article/0,,SB105588382470193600,00.html>

**Hyperlinks in this Article:**

(1) <mailto:jesse.drucker@wsj.com>

(2) <mailto:theo.francis@wsj.com>

*Updated June 18, 2003*

**Copyright 2003 Dow Jones & Company, Inc. All Rights Reserved**

**Printing, distribution, and use of this material is governed by your Subscription agreement and Copyright laws.**

**For information about subscribing go to <http://www.wsj.com>**