

The SEC's Proxy Disclosure Rules Tell Investors a Whole New Story about Executive Defined Benefit Retirement Plans

By Larry Schumer

The key intent of the newly finalized Securities and Exchange Commission's (SEC's) proxy disclosure rules is to give investors a handle on the total compensation that public companies pay to their senior executives. Until now, fully understanding this concept has been a complex undertaking because senior executives' total compensation is typically derived from numerous programs, and amounts were not disclosed for some of these programs.

This [insightout] focuses on perhaps the least understood component of that total compensation package — executive defined benefit retirement plans. For the first time, the new rules require companies to calculate the annual value earned by each named executive officer (NEO) under these retirement plans and annually disclose that value in the Summary Compensation Table.

The rules no longer allow companies to simply present a supplementary table in their proxy statements that provides general information — confusing and not very relevant information at that — about executives' estimated future retirement benefits. Instead, the rules open the actuarial black box so the annual values of these arrangements are prominently displayed as part of Total Compensation. In addition, the supplementary table has been revised to display the present value of each executive's accumulated benefit.

CUSTOMARY CURRENT PRACTICES

Top executives at a majority of large, public companies receive retirement benefits from one or two additional arrangements as well as from the company's qualified plans. The first arrangement, often called an "excess plan," provides benefits that are based on the executive's compensation in excess of the amount that the Internal Revenue Code allows companies to include in tax-qualified plans. (In 2006 this includable

compensation limit is \$220,000.) The excess plan usually uses the same formula for calculating the benefits as does the qualified defined benefit plan.

The second type of plan, a Supplemental Executive Retirement Plan (SERP), can utilize any formula and include any type of compensation in calculating the benefit. Many SERPs aim to provide a benefit that replaces 50 to 60 percent of an executive's pre-retirement "compensation" (which in most cases the SERP defines as base salary plus bonuses) assuming a "full career" with the company lasting 20 to 30 years.

DOING THE MATH ON FOUR CEO'S RETIREMENT PACKAGES

In order to understand how the benefit values to be disclosed in the proxy statement's Summary Compensation Table are calculated under the SEC's methodology, Figure 1 shows compensation numbers for four CEOs in the following fairly common situations:

- Long-tenured CEO with a SERP in place for many years
- Existing CEO with an amended employment contract creating much larger retirement benefits
- Newly hired CEO with a SERP
- Existing CEO entitled to a large, one-time compensation amount

Figure 1 | Retirement Plan Annual Values for Four Sample CEOs Under New SEC Rules

	Long Tenured CEO; SERP in Place for Many Years	Existing CEO with New SERP Enhancing Retirement Package	Newly Hired CEO with SERP	Existing CEO with SERP with Large, One Time Compensation Amount
Age at Hire	35	35	52	40
Age becomes CEO	50	50	52	55
Current Age	55	58	53	60
Supplemental Executive Retirement Plan ('SERP') Benefit (Inclusive of any Qualified Plan)	2% of 3 yr average compensation (Base + All Bonuses) times all years of service	Same as 1st CEO (previously, CEO was in qualified plan equal to 1.25% of 3 yr average compensation times service with ERISA excess plan)	50% of 3 yr average compensation, if retirement at age 65, less prior employer retirement benefits (assumed to be \$270k per year)	Same as 1st CEO
Base Compensation	\$500,000	\$500,000	\$800,000	\$1,000,000
Bonus Compensation	\$500,000	\$500,000	\$800,000	\$2,000,000
Special Bonus Compensation	N/A	N/A	N/A	\$5,000,000
Total Plan Compensation	1,000,000	1,000,000	1,600,000	\$8,000,000
Accumulated, Annual Benefit, End of Prior Fiscal Year	\$350,000	\$250,000	\$0	\$1,050,000
Accumulated, Annual Benefit, End of Current Fiscal Year	\$380,000	\$440,000	\$40,000	\$1,820,000
Present Value of Accumulated Plan Benefits, End of Prior Fiscal Year	\$2,010,000	\$1,730,000	\$0	\$8,080,000
Present Value of Accumulated Plan Benefits, End of Current Fiscal Year	\$2,330,000	\$3,200,000	\$220,000	\$14,790,000
Annual Retirement Plan Values:				
Change in Pension Value (Difference in Present Value of Accumulated Plan Benefits From Prior to Current Fiscal Year)	\$320,000	\$1,470,000	\$220,000	\$6,710,000
Value as % of Plan Compensation	32%	147%	14%	84%

The executives' ages (a) at hire, (b) when they became CEO and (c) currently, and compensation amounts are shown in Figure 1. Also presented are the SERP benefits. Three of the four receive benefits equal to two percent of final three-year average compensation (base salary plus bonuses) times years of service. Our third example, the newly hired 52-year-old CEO, has negotiated a flat 50 percent of the average of his final three years of compensation (assuming he stays to normal retirement at age 65) offset by the retirement benefits he had earned at his prior employer.

The figure then presents the annual accumulated benefits (often also referred to as 'accrued benefits') at the end of both the prior and current fiscal years. The accumulated benefit will increase to reflect an additional year of service and any increases in the executive's average three-year compensation. The next two rows show the present values of the accumulated benefits at the two points in time: the end of the prior and current fiscal years. The present value will increase over the year due to (a) changes in the benefit and (b) interest. The final rows show the Change in Pension Value, the amount now to be disclosed in the Summary Compensation Table, in dollars and as a percentage of the sum of base salary and bonuses.

In determining this value, the final rules require the use of assumptions used in a company's financial statement calculations under FAS 87, except for retirement age where normal retirement age must be used. For our examples, we use the following assumptions: six percent annual rate of interest, a retirement age of 65, four percent annual cash compensation increase assumption for prior years, and post-retirement mortality under the 1994 Group Annuity Mortality table.

There are two other important points to make regarding assumptions. First, since the rules do not permit use of an early retirement assumption, our calculations also do not reflect any other pre-retirement assumptions such as turnover or death.

Second, the rule requires those calculating the benefit to take the difference between the present values of the accumulated benefit from two different points in time (end of current and prior fiscal years). Each of the two dates has its own interest rate (called the discount rate under FAS 87) and, therefore, the

amount disclosed will also reflect any change in the rate. If the rate were to increase significantly over the year, it is possible for the Change in Pension Value to be negative. If so, a \$0 amount goes in the column and the negative amount is presented in a footnote.

IT ADDS UP

The value for the long-tenured CEO, probably the most common situation, comes in at 32 percent of plan compensation. Do most compensation committees know that this arrangement provides that much additional (deferred) compensation? Perhaps not, but they may be equally unlikely to realize the size of the retirement benefit provided in other situations. Consider the next three.

For the second CEO, the company amended her employment contract to establish a SERP providing a sizable increase in her retirement benefit. Under the SEC's methodology, an extremely large value would be disclosed equal to 147 percent of plan compensation. This is because the accumulated benefit, and its present value, under the new SERP formula (two percent per year of service times plan compensation) is much higher than under the prior excess plan formula of 1.25 percent per year of service. Furthermore, the value calculation is based on the individual's age with those older having larger present values. The compensation committee likely may not have fully appreciated that the new SERP formula would yield a value of this magnitude in the year of change.

The third CEO comes in at a modest 14 percent of plan compensation primarily because the benefit already earned at a prior employer is offset — as it should be — from the value of the new employer's promised pension.

Finally for the CEO who has received a large, special bonus for an extraordinary accomplishment, the value to be disclosed equals 84 percent of plan compensation. This value is more than 200 percent greater than the sum of his salary and regular annual bonus. This is because his accumulated benefit is significantly augmented by the inclusion of the \$5 million special bonus in calculating his average compensation, and he is only two years away from retirement.

Again, there are several reasons why all of these benefits should be considered significant. First, start with a benefit level designed to provide a generous benefit. Then add to that a definition of plan compensation that includes regular and special bonuses. In addition, because many NEOs are in their 50s or 60s, the present value factors create values that are large multiples of the benefits being earned. When an unusual event affecting retirement benefits occurs, as with the second and fourth CEOs, the SEC's methodology results in an extremely large increase in the accumulated benefit and resulting present value due to the requirement to recognize the full present value of the increased benefit in one year.

OTHER PENSION PLAN CHANGES

The disclosure requirements regarding the annual value in the Summary Compensation Table are the most significant of the rules related to executive retirement plans. However, the SEC's rules also make changes in two other areas of pension plan proxy disclosures.

First, the Pension Plan Table that previously presented a chart of the annual benefits that the NEOs might be projected to receive has been replaced with a new table, called the Pension Benefits Table. This table — with only a few columns that principally disclose the present value of the accumulated benefit — is integral to the calculation of the Pension Value in the Summary Compensation Table. This makes sense, and in fact, Buck Consultants suggested this to the SEC in its comment letter. One complicating aspect to this table is the requirement to present separately each plan in which each NEO participates and, therefore, to quantify separate amounts from each plan.

The final area of the proxy statement where executives' pensions may appear is in the disclosure entitled *Other Potential Post-Employment Payments*. This narrative section describes payments that would be made to named executives upon termination or change in control, assuming that the event were to happen on the last day of the fiscal year. For example, the value of special pension enhancements — such as

elimination of early retirement reduction factors, accelerated vesting, or credit for additional years of service — resulting from such an event will need to be calculated and disclosed. To the extent that pension benefits are already earned without regard to the assumed termination or change in control and disclosed in the Pension Benefits Table, reference may be made to that disclosure.

WHAT NOW FOR COMPENSATION COMMITTEES AND MANAGEMENT

As shown, the values to be disclosed will often be meaningful both in absolute terms and relative to other executive compensation elements. Because they are meaningful and, going forward, will be disclosed, compensation committee members will want to have a clear understanding of how they are calculated. In addition, committees must now focus on total compensation but some have not factored in the value of pension benefits in the past. This revised approach to quantifying pension benefits will enable committees to better measure total compensation and, therefore, to assess the competitiveness of their executives' *entire* packages.

We suggest that companies work on their executive retirement plan disclosures now. The compensation committee will need time to get comfortable with the new disclosures, as well as to assess whether any changes to the plan should be considered. Analyzing a specific situation and making any changes surely will take time. In another *[insightout]* in the coming months, we will explore the changing landscape of executive retirement programs.

ABOUT THE AUTHOR

Larry Schumer is a principal in the Boston compensation consulting practice at Buck Consultants, An ACS Company. He has more than twenty years of compensation and benefits consulting experience specializing in the areas of executive compensation. Larry can be reached at 617.275.8048 or larry.schumer@buckconsultants.com.