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# Asymmetric treatment of reported pension expense and income amounts in CEO cash compensation calculations ☆

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**Abstract**

We provide evidence that CEO cash compensation is relatively less sensitive to pension expense than pension income, suggesting that compensation committees shield CEO cash compensation from pension expense amounts. We also provide evidence that managers use relatively higher expected rate of return estimates when reporting pension income, suggesting that managers select income-increasing accounting estimates in response to compensation committees' greater emphasis on pension income in CEO cash compensation determinations. Pension cost amounts represent a unique setting to examine such behavior as their effect on CEO cash compensation can be detrimental or beneficial, but arise from the same underlying economic activity.


*JEL Classification:* M41

*Keywords:* Executive compensation; Earnings management; Pension expected rate of return estimate

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## 1. Introduction

A large body of accounting research has examined the link between executive compensation and reported earnings. A pervasive finding in this literature is that when determining CEO cash compensation, compensation committees adjust for items in reported earnings in order to provide proper incentives for CEOs to engage in activities that enhance firm value—particularly when CEO cash compensation would have been lower absent the adjustment. For instance, Dechow et al. (1994) and Adut et al. (2003) provide evidence that compensation committees shield CEO cash compensation from restructuring charges. However, such adjustments create an incentive for CEOs and other managers to opportunistically exert influence over compensation committees to shield compensation formulas from earnings amounts that adversely affect their compensation (Bebchuk et al., 2002).

In this paper, we examine whether compensation committees shield CEO cash compensation formulas from recurring operating expenses to a greater degree than for recurring operating income.[1] Specifically, we examine whether compensation committees adjust compensation formulas for reported pension costs, an above-the-line item that can be either negative (pension expense) or positive (pension income) on a net basis, and can therefore have either an adverse or a beneficial effect on CEO cash compensation. Net pension expense (income) arises when the expected return on pension plan assets is smaller (larger) than the sum of the other pension cost components, primarily service and interest costs. Our sample firms report pension income nearly 30% of the time, and both pension expense and pension income represent economically significant amounts for firms with defined benefit plans.

Our examination of pension cost amounts is motivated by concerns among shareholder groups, unions, and the financial press that compensation formulas are opportunistically adjusted for these amounts (e.g., Calabrese, 2002). Such concerns arise because of the possibility that managers take advantage of the complexity and subjectivity associated with pension accounting rules under *Statement of Financial Accounting Standards No.* 87: *Employer's Accounting for Pensions* (*SFAS* 87, FASB, 1985) to influence compensation committees' treatment of pension costs.

We then examine whether compensation committees' shielding of CEO cash compensation formulas motivates managers to select accounting estimates that increase their compensation. Specifically, we examine whether compensation committees' adjustment of compensation formulas for reported pension costs leads managers to opportunistically select expected rate of return estimates for pension plan assets—i.e.,

[1]In research closest to the current study, Gaver and Gaver (1998) provide evidence that compensation committees make CEO cash compensation less sensitive to above-the-line net losses relative to above-the-line net profits, consistent with CEOs not being awarded a bonus in the former case and being above the lower bonus threshold in the latter case (Healy, 1985). Gaver and Gaver (1998) also provide evidence that below-the-line gains arising from extraordinary transactions, discontinued operations, and nonrecurring items are positively related to CEO cash compensation, while CEO cash compensation is shielded from losses for these items. As Gaver and Gaver (1998) discuss, the asymmetric treatment of these gains and losses in CEO cash compensation formulas can be interpreted as evidence of either managerial influence over compensation formulas or efficient contracting. That is, the sheltering of CEO cash compensation from such losses could be attributable to decisions that increase firm value (e.g., the closing of an unprofitable segment) or attributable to sheltering CEO cash compensation from exogenous losses (e.g., natural disasters).