

## The Use of Adjustments to GAAP Metrics in Executive Incentives

With the recent elimination of the performance-based exception to deductible compensation limits under IRC Section 162(m), companies will have the opportunity to simplify their incentive structures. No longer facing requirements for “pre-establishing” goals and setting targets within a strict time line, companies will have greater flexibility and freedom to determine the performance metrics and targets used in their incentive plans.

This flexibility comes at a time when investors and other stakeholders are paying increasing attention to how companies select metrics and set targets in their executive incentive plans. One of the most challenging issues in this debate involves the appropriateness of using metrics that incorporate “adjustments” to publicly reported measures that conform to Generally Accepted Accounting Principles (or, GAAP). In 2017, 95% of companies in the S&P 500 disclosed at least one non-GAAP metric<sup>1</sup>, and the use of incentive plan metrics that incorporate adjustments to GAAP is commonplace.

The use of non-GAAP financial metrics reflects the desire to balance the interests of shareholders and management in the design of executive incentives. While investors can rightfully claim that using adjusted metrics undermines the alignment of interests between shareholders and managers, management has a legitimate interest in being rewarded for outcomes they can directly impact. Unfortunately, there is an emerging view - supported by some recent research - that the balance has tipped in favor of management. And as disclosures have become increasingly complex, investors struggle to understand exactly how the company’s financial performance translates into incentive plan payouts.

While we believe that the use of non-GAAP metrics is appropriate in limited circumstances, we

encourage companies to use adjustments sparingly, and to disclose both the rationale and the operation of the adjustments more clearly and proactively. A more restrained use of adjustments accompanied by increased transparency and more effective disclosure will help companies and investors ensure an equitable balance of interests.

### The Purpose of Generally Accepted Accounting Principles

To frame the discussion about the use of non-GAAP metrics in executive incentives, it’s helpful to start by reviewing the purpose and role of GAAP. Fundamentally, GAAP exists to provide consistent information to interested parties on the financial performance of a company. This enables the accurate and fair pricing of securities by allowing investors to have clear and consistent means to evaluate and compare company performance. However, as we’ve seen over the past several years, the use of non-GAAP measures to supplement the standard disclosures has expanded.<sup>2</sup> This expansion is a response to both investor demands for additional information upon which to evaluate performance, and management’s incentive to present its performance in the best possible light.

Because investors value and demand the information and insight provided by non-GAAP disclosures, we can reasonably assume that adjustments to standard disclosures can in fact facilitate greater insight into the true nature of a company’s performance. And this greater transparency is no doubt in the best interests of shareholders. Unfortunately, while there are many good reasons for adjusting GAAP metrics, problems arise when the key users of the information - investors - have concerns about the motivations of those making the adjustments. This

<sup>1</sup> “Non-GAAP Reporting One Year After New SEC Guidance,” Mercedes Ericsson, Audit Analytics, December 21, 2017, available at <http://www.auditanalytics.com/blog/non-gaap-reporting-one-year-after-new-sec-guidance/>.

<sup>2</sup> “Spotlight on non-GAAP financial measures,” *Technical Line*, No.. 2016-15, 28 April 2016, EY,

available at [http://www.ey.com/Publication/vwLUAssets/TechnicalLine\\_00785-161US\\_NonGAAP\\_28April2016/\\$FILE/TechnicalLine\\_00785-161US\\_NonGAAP\\_28April2016.pdf](http://www.ey.com/Publication/vwLUAssets/TechnicalLine_00785-161US_NonGAAP_28April2016/$FILE/TechnicalLine_00785-161US_NonGAAP_28April2016.pdf)

dilemma is what makes the use of adjusted financial metrics in executive incentives problematic.

## **The Use of Adjustments to GAAP Metrics in Incentives**

The selection of performance metrics is one of the most important aspects of the executive incentive design process. Companies translate business strategy into incentive plans via the metrics they choose to reward and the target levels of performance they establish. Creating a clear connection between business strategy, performance outcomes and management rewards is a key objective of executive pay programs.

But alignment between strategy, outcomes and rewards is only one part of the story. To be effective, an incentive plan must actually live up to its name by creating an effective inducement to drive differentially better results, and it must do so in a manner that is perceived as fair by its participants. A key element of the perceived fairness of a plan is that it should reward management for outcomes they can directly impact. Taken in this light, GAAP performance measures can create a problem, since they can be significantly impacted by factors managers can't control. More concerning is the possibility that a strict adherence to GAAP metrics could actually serve to discourage managers from making decisions that are in the best interests of the business. For example, managers may avoid restructuring the company or pursuing a major value-creating acquisition because the near-term impact of that decision on reported result may translate into a lower incentive payout.

In this light, the prudent use of adjustments to GAAP to recognize the realities of the impact of incentives on behavior can be viewed as reasonable. But to investors, the behavioral impact is only one part of the story. From the investor perspective, the purpose of executive compensation is to align the interest of management with those of shareholders, while providing incentives for better performance. Because shareholders are not insulated from the effects of external events, one-time actions or other "extraordinary" factors, their goal of alignment is not served by isolating management from the

downside risk created by those factors. Further, excluding the short-term impact of an action such as an acquisition or a restructuring allows management to realize the best of all worlds - annual incentive plan results that exclude the near-term pain, and long-term equity compensation that captures the longer-term gain.

A recent study found that the disclosure of non-GAAP metrics by a company was associated with significantly higher than expected levels of CEO pay - without any corresponding evidence that those metrics were better predictors of future performance than their GAAP equivalents.<sup>3</sup> This finding appears to refute the claim that non-GAAP measures are more representative of underlying and ongoing performance.

## **Establishing the Right Balance**

In our view, compensation committees should proceed with care when deciding whether and how to use incentive plan metrics that incorporate adjustments to GAAP. We encourage committees to engage management in a dialogue about the issue, using the following framework to guide the discussion.

### *Types of Adjustments*

Compensation committees should recognize that not all adjustments are viewed the same way by various stakeholders. Excluding stock compensation expense from the calculation of income in an incentive plan will be a cause for concern for many investors and other stakeholders; but excluding the impact of accounting standard changes that take effect after targets have been set is generally less controversial. Most adjustments fall in between these two extremes and require more thoughtful dialogue and debate. Committees should also consider establishing a materiality threshold for adjustments.

### *Guiding Principles*

Before defining the specific adjustments that will be permitted, management and the compensation committee should engage in a dialogue to define some basic guiding principles. One of the most important of these is that adjustments should

<sup>3</sup> "High Non-GAAP Earnings Predict Abnormally High CEO Pay," Nicholas Guest, S.P. Kothari, and Robert Pozen, September 2017.

address compensation “windfalls” in addition to protecting executives from downside risk. This is critical to assuring investors that adjustments are being made fairly and that the balance isn’t being tipped toward management’s interests. Similarly, committees should insist that the adjustments made to GAAP metrics that are disclosed in external financial reporting are consistent with the adjustments made to GAAP metrics for incentive plan purposes.

#### *Advance Communication and Regular Review*

Transparency and specificity are essential to ensuring executives believe the process is fair and equitable, and that investors have the information they need to truly understand how pay will be determined. Compensation Committees should ensure that the agreed upon adjustments are communicated at the beginning of the performance period. Recognizing that it is impossible to anticipate all potential external events, the committee should also ensure the timely review of additional potential exclusions throughout the performance period – not simply at the end of the period when pay decisions are being made.

#### *Transparent Disclosures*

Committees should ensure that the company’s proxy disclosure clearly describes both the mechanics of any adjustments to GAAP metrics, as well as the rationale for the adjustment. Making this information available in a clear, easy to read disclosure will help address any potential concerns on the part of investors that management is trying to obscure the linkage between pay and performance. Investors are increasingly skeptical about management’s motives when it comes to pay, and that skepticism is fueled by complex plans and disclosures that seemingly intentionally obscure the truth of what is happening.

#### *Unintended Consequences*

Committees should actively consider what, if any, unintended consequences may result from adopting adjustments to GAAP metrics. This may require taking a long view of how such adjustments impact behavior within the organization below the executive level. For example, the continued and persistent use of corporate “restructuring” as a mechanism to address sub-par performance or obsolete skills can, over time, erode an organization’s ability to create a culture of accountability. When poor performers can be

quietly exited using generous severance plans, and the cost of those plans is excluded from incentive plan results, attempts to create a strong performance orientation are compromised. Similarly, the exclusion of stock compensation expense from incentive results effectively creates a situation where equity compensation can be offered at a deep discount compared to other forms of pay; this may result in an unintentional distortion of pay mix to favor equity.

#### *The Role of Judgment*

At the end of the day, committees should take a step back and conduct a “sanity check” on how the adjustments have operated in the incentive plan. How will the end result be perceived by executives? By shareholders? By other stakeholders - employees, proxy advisory firms, the media? This review should be done in the context of the company’s overall executive compensation posture and relationship with its investors. Companies who have experienced challenges in Say on Pay votes may need to take a more conservative approach in approving adjustments and build credibility with investors over time.

#### **Conclusion**

We believe that the prudent use of adjustments to GAAP metrics is appropriate, to address the legitimate interest of management in a fair and reasonable rewards program. However, in order to maintain an equitable balance between the interests of management and those of investors, we encourage companies to use adjustments sparingly, and disclose both the rationale and the operation of the adjustments clearly. Increased transparency and more effective disclosure will help build investors’ trust in management and in the process by which executive pay is determined.