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Non-GAAP Measures in Executive Compensation

Matt Turner

PRESIDENT, EXECUTIVE COMPENSATION CONSULTING

Matt Turner, managing director in the Chicago office of Pearl Meyer, discusses several points that companies can weigh when determining when and how to use GAAP versus non-GAAP measures to determine performance.

Q. Do most companies use GAAP or non-GAAP earnings when looking at performance for pay purposes?

A: In my experience there is a mix of practices. Some companies rely solely on GAAP measures of profit, growth, and returns, but it is also quite common to find non-GAAP measures used. In any event, it's important to note that a majority of companies also use non-financial measures to determine at least a portion of incentive compensation. So most companies rely on at least some non-GAAP performance measurement for incentives.

Q. What are the pros and cons of using non-GAAP versus GAAP when determining executive pay?

A: GAAP, of course, provides a common standard that is well-understood by the business community. In general, GAAP measures provide a fair and accurate picture of firm performance. When looking at performance across a large number of companies, a standard measure is required. But for a particular company, or even industry, there are times when adjustments provide a better picture of core performance, or provide better signals and/or incentives within an organization.

For example, an earnings measure adjusted for cash versus accrued taxes (and/or other accrual to cash adjustments) might better reflect long-term performance for some businesses. Another example, fairly common, is looking at a return measure, like ROIC, with significant new investments or acquisitions suspended from the calculation until the following year. The idea is to avoid discouraging long-term investment, or "punishing" management for the right decisions. (Significant new investments typically drive down short-term ROIC because "invested capital" increases before the new investments can produce "return.") Finally, there are times when a firm may want to focus on the components earnings that are most under the control or influence of management, so non-operating earnings/expenses might be excluded.

There are two things to keep in mind here. First, performance measures used in incentive compensation plans are not intended to simply and mechanically communicate overall firm performance. Yes, we want strong correlation between incentive plan results and firm performance, and we absolutely want pay and performance aligned. But plans will be most effective as a tool of strategy execution if they recognize how management will respond to them.

Second, keep in mind that senior executives' pay is not tied solely to financial results. Share price (through stock options, restricted stock, and performance shares) is often the largest influence on variable pay. This is especially true for larger companies. For the sake of balancing “alignment” (pay tied to share price) and “line-of-sight” (pay tied more closely to decision-making), it often makes sense to have cash incentive tied to the latter objective.

Q. What should compensation committees keep in mind when looking at non-GAAP figures for pay purposes?

A: In one sense, compensation committees have the same set of concerns with non-GAAP measures that they do with GAAP measures. First, measures should have a demonstrable link to share price performance over the long-term and be relevant to the business strategy and economic context. Second, performance goals should be set specific to the company and its circumstances. It is not sufficient to say target performance is median of a peer group, or X% above last year’s performance. Shareholders may actually expect more (or less) than what they expect from other comparable companies.

But with non-GAAP measures, comp committees need to ensure that any adjustments are justified by the economics, are applied consistently over time (the measure cannot change every year), and that the rationale for the measure and adjustments are well-explained/disclosed to shareholders in the proxy.

This last point is an area where companies can and must do a better job.

About the Author

Matt Turner is the president of executive compensation and leads the executive and broad-based compensation consulting practices at Pearl Meyer. In his role, he oversees a team of senior compensation consultants in the execution of the firm’s growth strategy and in the development of consultants at various stages in their careers. He specializes in advising company boards and senior management on executive compensation strategy, incentive plan design, tailoring of performance measures, and the setting of shareholder-focused performance objectives.

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