

## Assessing ISS' Newly Selected GAAP Financial Metrics for CEO P4P Alignment: How Can Companies Respond?

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Say on Pay (SOP) and shareholder advisor vote recommendations have caused a dramatic increase in the use of relative total shareholder return (TSR) as a long-term incentive (LTI) plan performance metric. Relative TSR prevalence in LTI plans has nearly doubled over the past 5 years, used by approximately 50% of companies of all sizes and industries. This is largely due to shareholder advisors, such as Institutional Shareholder Services (ISS), using TSR as the primary metric in their *relative* pay for performance (P4P) quantitative evaluations. ISS is appropriately attempting to enhance its company performance assessment model by adding 6 metrics.<sup>1</sup> This new approach is clearly a response to critics, but it presents a new set of challenges.

**TSR, despite its imperfections, is arguably the best *single* metric for evaluating and comparing a company's long-term performance in order to make appropriate investment decisions and evaluate the alignment of CEO pay and performance.<sup>2</sup> However, this performance / investment perspective does *not* prove that relative TSR is the optimal *incentive* metric for the hundreds of companies that use it as a performance-vesting metric in their stock plans. Relative TSR's reputation as the sole or primary performance assessment metric by ISS, combined with its ubiquity as a performance-vesting condition, have drawn criticism<sup>3</sup> from companies and shareholders:**

- **Limited line of sight:** TSR measures the final outcome of a management's strategies and efforts to create value for shareholders. TSR or target stock prices may be a powerful incentive under specific circumstances;

### Key Takeaways

- ISS uses TSR as the sole metric in its key SOP quantitative test of the "alignment" of CEO pay and performance relative to peers. This has received some valid criticisms from companies and shareholders. The use of TSR as the sole alignment metric has pressured many companies to utilize relative TSR as a performance-vesting condition in their performance share plans.
- In response to such criticism, ISS has incorporated GAAP financial metrics into their qualitative P4P evaluations. ISS is considering incorporating these additional metrics into their quantitative assessment. This new approach addresses some of the criticisms of TSR but also creates new, significant challenges.
- This could create additional pressure on companies to incorporate the ISS selected financial metrics into their incentive programs. Instead, companies should continue to focus on metrics that are relevant to their business strategy, shareholder alignment, and executive motivation.
- Non-GAAP metrics, strategic objectives, or other GAAP metrics not reviewed by ISS may be more relevant for a company's specific circumstances. These metrics could also be much more motivational for focus and controllable/core earnings growth.
- Recent academic studies and research support the relevance and use of non-GAAP/adjusted earnings over GAAP earnings.
- Companies will need to make the case to shareholders in their CD&A to justify the appropriateness of the company-selected metrics.
- Over time, focusing on the company-specific drivers of value creation will translate into shareholder value creation and positive SOP outcomes.

<sup>1</sup> Glass Lewis already uses financial metrics in addition to TSR in its P4P assessment. We focus on ISS because they influence more shareholder votes and have a more transparent model.

<sup>2</sup> The predominant quantitative P4P test in the ISS model uses relative TSR exclusively, measured against relative CEO pay from the Summary Compensation Table, which discloses the grant date value of stock and options. This method causes many "false negatives" because it does not utilize realizable pay to evaluate alignment. The new metrics will not resolve this fundamental problem with their model.

<sup>3</sup> "Directors'dilemma: responding to the rise of passive investing." Goldman Sachs. Global Markets Institute. January 2017.

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however, TSR does not provide specific direction or motivation towards management's priorities: the drivers of value creation as well as strategic and operational areas. Relative TSR, as an incentive metric, has even lower direct motivational power.

- **Outside factors:** There are multiple factors beyond the management team's control that impact TSR: even successful management efforts do not always translate directly into superior TSR performance. Management could do everything right to drive value creation, but other macroeconomic or industry sector factors could negatively impact short-term stock prices. Conversely, management could destroy enterprise value through strategies that generate returns below the cost of capital while other factors create a positive stock price swing. The Investor Responsibility Research Center<sup>4</sup> has demonstrated flaws created by the shareholder advisors' focus on TSR as the primary basis for SOP vote recommendations. Relative TSR has its own set of complications.

**In response to such criticisms, ISS has incorporated additional Generally Accepted Accounting Principles (GAAP) financial metrics into the qualitative component of their relative P4P evaluations.**

- ISS 2017 policy survey results show that the majority of investors and issuers support — or strongly support — incorporating other financial metrics into the quantitative assessment of CEO pay and performance.<sup>5</sup> *While it is reasonable to incorporate additional metrics into a P4P assessment, a rigid and standardized approach for thousands of companies could cause substantial “false negatives” (low GAAP performance when there is high adjusted performance and/or rising stock price).*
- For the 2017 P4P assessment, ISS has incorporated 6 financial metrics as part of its qualitative assessment. The metrics include Return on Invested Capital, Return on Equity, Return on Assets, as well as Earnings before Interest, Taxes, Depreciation, and Amortization (EBITDA) growth, cash flow growth, and revenue growth. The specific weighting given to each metric will vary by industry.
- Undisclosed weightings are assigned to each metric used based on the subject company's industry and the corresponding ranking of each metric. The metrics are ranked in order of priority/relevance for each industry.
- ISS will use reported GAAP results rather than adjusted performance results. There are obvious efficiencies and advantages to this, but the particulars of each company could be lost in the shuffle. However, the vast majority of companies use non-GAAP (adjusted) results in earnings releases and incentive plans.<sup>6</sup> As has been demonstrated repeatedly, this trend has been endorsed — with caveats — by analysts and shareholders. Research and experience indicate that adjusted results are correlated more closely with stock price performance than with GAAP.

**While this methodology change addresses TSR's “one-size-fits-all” problem, it creates more problems than it solves. First, business model differences caused by strategic differences, technology disruptions, global markets, regulatory pressures, etc., can be significant enough to prevent valid company-to-company comparisons from a preselected set of rigidly-defined metrics and their actual GAAP performance levels — even between companies in the same industry.<sup>7</sup> Second, ISS' imprimatur of a metric could encourage/**

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<sup>4</sup> Mark Van Clieaf and Karel Leeftang. “The Alignment Gap Between Say on Pay Voting and Creating Value.” The Investor Responsibility Research Center Institute. December 22, 2014. <http://irrcinstitute.org/wp-content/uploads/2015/09/final-sop-dec-20141.pdf>.

<sup>5</sup> “ISS Announces Pay-for-Performance Methodology Updates for 2017: Six New Financial Metrics to Supplement TSR.” Institutional Shareholder Services Inc. November 8, 2016. <https://www.issgovernance.com/iss-announces-pay-performance-methodology-updates-2017/>

<sup>6</sup> Jason Voss. “Non-GAAP Business Performance Measures: An Investor Perspective.” CFA Institute. June 29, 2016.

<https://blogs.cfainstitute.org/investor/2016/06/29/non-gaap-business-performance-measures-an-investor-perspective/>.

<sup>7</sup> As advisors to boards of major companies, we also use TSR and GAAP metrics to evaluate P4P alignment. However, our assessment remains qualitative and does not have the regulatory and governance implications of an ISS “against” recommendation or a low SOP vote.

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pressure companies to choose that metric in their incentive plans — similar to the surge of relative TSR in LTI plans. This selection could be made despite a metric's lack of strategic fit and other disconnects.

Our experience is that the vast majority of companies choose the metrics used in their incentive plans carefully; our concern is that these ISS/SOP issues could interfere.

### **Focus on performance metrics that are relevant for your business strategy**

Pay Governance encourages companies to focus on incentive plan metrics that are relevant to their unique business strategies; this may include metrics beyond those evaluated by ISS. Some metrics reviewed by ISS may not be relevant for performance comparisons in certain industries, and some companies may decide that non-financial metrics or strategic objectives are important drivers of value creation for the business. We find non-financial metrics and strategic objectives in use in both annual incentive and performance share unit (PSU) programs.

### **Adjusted (non-GAAP) metrics may be more relevant for some companies**

Most investment analysts use adjusted earnings to value a company's stock price. This implies that companies do not necessarily trade on GAAP metrics, trading instead on adjusted metrics, which better track the future operational performance of a company by eliminating non-recurring expenses. Advocates of adjusted metrics believe that selected adjustments — typically increasing reported results — are needed to produce metrics more attuned to the realities of the business and more reflective of the value added from period to period. For example, certain expense items might be excluded from (added back to) earnings to obtain a clear view of ongoing operating results, such as:

- One-time realized gains/losses
- One-time events such as mergers/acquisitions/restructuring/divestitures
- Adjustments for accounting rule changes
- The reversal of asset impairment charges
- The impact of foreign exchange
- Non-recurring income/expenses

The use of GAAP and non-GAAP metrics for earning releases and incentive plans has become common, crucial, and controversial. While there are criticisms of non-GAAP earnings,<sup>8</sup> boards and shareholders have clearly embraced their use.<sup>9</sup> Research shows that the use of adjusted (non-GAAP) metrics to disclose performance to shareholders has grown from 358 (72%) S&P 500 companies in 2009 to 448 (90%) in 2015.<sup>6</sup>

A review of the economic research on this topic (cited in the table below) supports the relevance and use of adjusted earnings over GAAP earnings. This indicates that ISS' use of GAAP performance could lead to incorrect conclusions on P4P alignment.

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<sup>8</sup> For example: Sam McBride. "Non-GAAP Earnings Boost Executive Pay At The Expense Of Shareholders. New Constructs. October 29, 2015. <https://www.newconstructs.com/non-gAAP-earnings-boost-executive-pay-expense-shareholders/>

<sup>9</sup> The SEC had promulgated specific rules for usage and reconciliation of GAAP and non-GAAP metrics: Non-GAAP Financial measures. U.S. Securities and Exchange Commission. May 17, 2016. <https://www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm>.

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Article (Date)	Research Findings
1. <b>Surprise: Investors Like Non-GAAP Earnings (2017)</b> <sup>10</sup>	<ul style="list-style-type: none"> <li>• “[Researchers] correlated both the percentage changes in GAAP and non-GAAP earnings ... across [a sample of 265 S&amp;P 500 companies], with the three-day share price reaction to the earnings releases...</li> <li>• “...the change in GAAP earnings is uncorrelated with the surrounding share-price change (namely, was ignored by investors), whereas the change in non-GAAP earnings was positively-and statistically significantly-correlated with the price change around the release.”</li> </ul>
2. <b>Do Non-GAAP Earnings Adjustments Deliver Comparability Benefits? (2016)</b> <sup>11</sup>	<ul style="list-style-type: none"> <li>• “This paper examines the comparability of non-GAAP earnings vs GAAP earnings.</li> <li>• “Comparability implies the ability of earnings to capture similarities and differences between companies.</li> <li>• “The findings indicate that street earnings are significantly more comparable than GAAP earnings, supporting the benefit of non-GAAP adjustments by analysts.</li> <li>• “Moreover, the superior comparability of street earnings is likely attributed to the removal of material nonrecurring items and recurring items with considerable measurement errors.”</li> </ul>
3. <b>Non-GAAP Earnings and Value Relevance. Can a Case be made for the Deregulation of Corporate Financial Disclosure? (2015)</b> <sup>12</sup>	<ul style="list-style-type: none"> <li>• “Bradshaw and Sloan’s (2002) article titled ‘GAAP versus the Street: An Empirical Assessment of Two Alternative Definitions of Earnings’ has been pivotal in recognizing the growing association between non-GAAP earnings and value relevance.</li> <li>• “Moreover, these findings are consistent with research documenting the declining value relevance of GAAP earnings...</li> <li>• “As Albring [et al] find, non-GAAP earnings, such as Street and pro forma, are more value relevant because reported earnings are robust and adjustable for potential outliers.</li> <li>• “Observing the predilection of management, analysts, and investors alike toward non-GAAP earnings, a strong theoretical case can be made for a free market approach to corporate financial disclosure.”</li> </ul>
4. <b>Classification Shifting and the Value Relevance of non-GAAP and GAAP Earnings (2016)</b> <sup>13</sup>	<ul style="list-style-type: none"> <li>• “These findings imply that investors focus more on non-GAAP than on GAAP earnings during earnings announcements, which indicates that non-GAAP earnings are found to be more permanent than GAAP earnings.”</li> </ul>
5. <b>GAAP versus The Street: An Empirical Assessment of Two Alternative Definitions of Earnings (2002)</b> <sup>14</sup>	<ul style="list-style-type: none"> <li>• “Managers, security analysts, investors, and the press rely increasingly on modified definitions of GAAP net income, known by such names as “operating” and “pro forma” earnings.</li> <li>• “We also show that the market response to the Street earnings number has displaced GAAP earnings as a primary determinant of stock prices.”</li> </ul>
6. <b>The value relevance of a non-GAAP performance metric to the capital markets (2010)</b> <sup>15</sup>	<ul style="list-style-type: none"> <li>• “Results show that the explicitly defined non - GAAP measure used is significantly associated with equity market values and returns and is significantly more value - relevant than the GAAP measure.”</li> </ul>

<sup>10</sup> Feng Gu and Baruch Lev. Seeking Alpha. <https://seekingalpha.com/article/4060911-surprise-investors-like-non-gaap-earnings>.

<sup>11</sup> Jancheng Liu and Zhan Gao. Lancaster University Management School. <https://ssrn.com/abstract=2878768>.

<sup>12</sup> Tom Lillywhite. Australian National University. <https://www.linkedin.com/pulse/non-gaap-earnings-value-relevance-can-case-made-tom-lillywhite>.

<sup>13</sup> Ercan Simsek. Erasmus School of Economics. [https://thesis.eur.nl/pub/36517/M2-Simsek\\_361167.pdf](https://thesis.eur.nl/pub/36517/M2-Simsek_361167.pdf).

<sup>14</sup> Mark T. Bradshaw and Richard G. Sloan. Journal of Accounting Research. [http://sites.fas.harvard.edu/~ec970lt/Readings/April\\_18/Bradshaw\\_Sloan\\_2002.pdf](http://sites.fas.harvard.edu/~ec970lt/Readings/April_18/Bradshaw_Sloan_2002.pdf).

<sup>15</sup> Susan M Albring et al. Review of Accounting and Finance. <http://www.emeraldinsight.com/doi/abs/10.1108/14757701011068066>.

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### Making the case to shareholders to justify selected metrics

Companies need to focus on disclosure, ensuring that shareholders understand the rationale for selecting certain performance measures for incentive plans. Typically, non-GAAP metrics are chosen to focus management on core operating profit and exclude economic and other factors outside of management's direct control. There may be situations where a company's performance on GAAP metrics produces less favorable results relative to peers than adjusted non-GAAP metrics — where non-GAAP results could be more indicative of the company's true economic business and operations.. In such cases, ISS might have a *negative* relative assessment of the company's performance based on their selected GAAP metric, but management and investors, aware of a potential one-time negative event, might evaluate the company's performance *positively* after allowing for the event. In these cases, companies may need to explain to the broader shareholder population why the adjusted metrics are a better focus than the ISS GAAP metric. Addressing any scrutiny over the use of adjusted financial results or other metrics not selected by ISS and used to calculate incentive payouts can be accomplished by strong disclosure in the Compensation Discussion & Analysis (CD&A). Companies should be sensitive to the Securities and Exchange Commission's specific rules regarding non-GAAP metrics.<sup>9</sup>

### Conclusion

Companies should continue to use metrics strategically and carefully for their incentive plans and be careful in relying on the financial metrics selected by ISS for its P4P assessments. The preferred metrics may be non-GAAP metrics, strategic objectives, or certain GAAP metrics other than the ones selected by ISS as part of their qualitative and possible quantitative review. In addition to rigorous goal setting, companies should consider a thorough review of the chosen metrics in the context of the link to shareholder value creation, strategy, business model, and motivation of management.

Over time, focusing on company-specific drivers of value creation will translate into shareholder value creation, greater clarity to incentive plan participants as to organizational priorities, and positive SOP outcomes.