Mind the non-GAAP:
Does Say-on-Pay Provoke non-GAAP Reporting?

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Say-on-Pay and non-GAAP[1] reporting are two recent key changes in corporate norms that have drastically changed the financial governance of organizations in Canada and across the world. My research delves deeper to investigate the association between these two recent practices, and the factors that may influence Say-on-Pay.

On January 2, 2020, the Canadian Centre for Policy Alternatives (CCPA) expressed its concern regarding the rise in CEO pay, which has reached a record level compared with average worker compensation. In such a context, shareholders now have the opportunity to express their satisfaction about executives' compensation packages through Say-on-Pay. Say-on-Pay is a governance practice, which is either mandated or voluntary, that provides shareholders with the right to vote on executive pay. Since its first appearance in the UK in 2002, it has subsequently been globally adopted in different forms. While the practice is voluntary in Canada, there is a movement towards mandating certain federally incorporated firms under the Canada Business Corporations Act (CBCA) to disclose their approach to executive remuneration and to hold an annual non-binding shareholder Say-on-Pay vote, similar to its practice in the U.S.

On the one hand, proponents consider Say-on-Pay to be an effective governance mechanism that provides shareholders with a voice on executive pay (Balsam, Boone, Liu, & Yin, 2016; Ferri & Maber, 2013). On the other hand, opponents argue that non-binding votes may be ignored and, worse, may even be viewed as an interference in board's role and its expertise in determining what constitutes fair pay (Alissa, 2015; Cai & Walkling, 2011). While Say-on-Pay has yet to become a legal requirement in Canada, its adoption has been on the rise among Canadian public firms, reaching 78 percent of TSX 60 firms and 48 percent of TSX listed issuers in 2018 (Davies, 2018). In this context, Canadian corporations would be wise to leverage the learning experiences of these early adopters and of firms in mandatorily adopting counties to determine the effectiveness of Say-on-Pay as a governance mechanism and potential safeguards to mitigate unintended consequences.

Among these possible unintended consequences, in their December (2019) study, the Canadian Coalition for Good Governance (CCGG) reported a significant increase in the prevalence of non-GAAP measures in compensation plans among Canadian listed firms. The CCGG also reported that several Canadian firms had adjusted their metrics in order to inflate firm performance thereby leading to higher compensation awards. From a governance perspective, the widespread use of non-GAAP performance metrics in the determination of executive compensation raises several concerns. For instance, in contrast to GAAP metrics, non-GAAP metrics are typically unaudited, thus raising questions as to their reliability. Moreover, CEOs

[1] GAAP: Generally Accepted Accounting Principles. The expression typically refers to numbers that are extracted from audited financial statements that are prepared according to prescribed accounting standards.

facing shareholders' votes on compensation plans may use non-GAAP measurements opportunistically to emphasize firms' earnings and performance. In an effort to control the opportunistic use of non-GAAP reporting, on February 13, 2020, the Canadian Securities Administrators (CSA) published a second notice and request for comment on revisions to the proposed rule for Non-GAAP and Other Financial Measures (Proposed National Instrument 52-112). The CSA's Proposed Instrument would provide clear and comprehensive requirements for the presentation of non-GAAP measures to ensure that they do not misrepresent a firm's core operations and performance to investors. Similarly, the Council of Institutional Investors (CII) expressed their concern on the opportunistic use of non-GAAP reporting in the Compensation Discussion & Analysis (CD&A) section in the petition sent to the U.S. Securities and Exchange Commission (SEC) in April 2019. However, the proposal and the petition may not necessarily offer a complete long-term solution to mitigate the aforementioned concerns (Singerman, 2018).

Against this backdrop, my dissertation examines the impact of the introduction of the Say-on-Pay regulation on the prevalence and quality of non-GAAP reporting for a sample consisting of the largest 250 U.S. firms. In particular, the study investigates whether non-GAAP metrics are reported in an attempt to mislead shareholders on firm performance and to avoid shareholder dissatisfaction which may impact executive compensation via the Say-on-Pay vote. Results confirm that managers increasingly disclose non-GAAP earnings and opportunistically exclude recurring items after the adoption of Say-on-Pay. Moreover, managers' opportunistic behaviour in non-GAAP reporting is more pronounced in the years when the firm is subject to a vote compared to the years when the firm is not exposed to shareholders' vote.

In addition to the unintended consequences of Say-on-Pay, indirect factors may influence shareholders' voting decisions. I extend the research that mainly focuses on examining how the level and structure of executive compensation shape shareholders' votes by studying the influence of the compensation committee quality on shareholders via their Say-on-Pay votes. Results confirm that factors other than the compensation itself may influence shareholders. Firms with higher compensation committee quality signal to shareholders that the compensation package is well-aligned with firm performance, thus gaining shareholders' support. I follow Sun and Cahan (2009) to measure the quality; the measure is an aggregate score that represents the proportion of directors appointed by the CEO, their experience, other executive roles they hold, their ownership in the firm, the number of boards they serve, and the size of the committee.

The results of my research will help policy makers to determine the effectiveness of Say-on-Pay as a governance mechanism. Learning from the experience of early adopters in a mandatory context, Canadian policy makers will be able to identify the value of moving forward with the CBCA's proposed amendment.

Moreover, the results provide additional support for the ethical concerns raised by non-GAAP reporting and the CSA's efforts in regulating these metrics. This research sheds light on managers' intentions to mislead shareholders about firm performance to gain favourable votes. Finally, policy makers would be aware of any unrecognized factors that may influence shareholders' Say-on-Pay judgements about CEO's compensation package. While policy makers have set the regulation to curb excessive executive pay through shareholders' votes, this study reveals that factors other than excess pay itself may influence their perceptions.

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