

INTRODUCTION

In the normal course of our review of corporate disclosure and ongoing engagement with public company boards over the past several years, CCGG has noted an increasing prominence of non-GAAP performance measures in the incentive compensation programs (both short-term and long-term) of Canadian public companies. It is not uncommon for boards to apply the highest weighting to these unaudited and, often, adjusted measures when determining incentive compensation awards for senior management. In an attempt to quantify the extent to which these measures are being used by boards to make important compensation decisions, CCGG undertook a study in early 2019 of the compensation structures of a representative group of 100 public companies listed on the S&P/TSX Composite Index (the “CCGG 100”). This group included companies from all sectors and with market capitalizations ranging from approximately \$500 million to over \$100 billion. The following report provides additional context and a summary of the highlights of our study. It also includes recommendations for improved disclosure on the use of these measures by public company boards.

It is important to acknowledge that the increase in reporting and use of non-GAAP performance measures by public companies has, to a significant extent, been encouraged by institutional investors and analysts seeking greater understanding of the key performance drivers of a particular business. Our decision to undertake this analysis and the results themselves are not intended to suggest that the use of these measures by boards to inform compensation decisions is somehow inappropriate. It does, however, highlight a number of important points for issuers and investors to consider, including:

- Non-GAAP measures are frequently incorporated into executive compensation plans and, in most cases, are the highest-weighted determinant of variable compensation awards.
- Variable compensation awards (i.e. STIP and LTIP programs) typically represent a significant majority of the total direct compensation awarded to senior management.

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- Despite the relative importance placed on these measures, the Compensation Discussion & Analysis (CD&A) disclosure included in most proxy circulars does not provide important information for investors, including:
 - a. an acknowledgement of the board’s responsibility for vetting these performance measures and scrutinizing any adjustments proposed by management, along with a discussion of the process involved in doing so,
 - b. an explanation of the parameters used by the board to determine the appropriateness of individual adjustments and rationale for any material adjustments made in the previous year,
 - c. clear definitions of all measures used,
 - d. where applicable, a detailed reconciliation of the measures used to their nearest GAAP equivalent and some context regarding the magnitude and trend of adjustments historically approved by the board,
 - e. confirmation as to the year-over-year consistency in calculation of these measures or, alternatively, disclosure of changes made to calculation methodology, along with a rationale for such changes and their implications in terms of year-over-year comparability of performance measures,
 - f. any involvement of independent third parties in the review process (for example, in ensuring year-over-year consistency in the calculation of key metrics).

CCGG welcomes any feedback issuers or institutional investors may have on this report and its recommendations. Please feel free to contact us at:

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BACKGROUND

What prompted us to undertake a study?

Through its board engagement program, CCGG meets annually with board representatives of approximately 40 public companies that are typically members of the S&P/TSX Composite Index. The focus of these private meetings is on governance and encompasses matters within the purview of the board, including executive compensation. In recent years, in preparing for these meetings, CCGG has observed that the incentive compensation structures used by many boards rely heavily on non-GAAP financial measures to determine the size of compensation awards. Furthermore, the definitions provided for these measures are often quite broad and allow for a range of potential adjustments; thereby introducing substantial discretion into the process. Despite the prominent role these figures play in determining a large proportion of management compensation, we also noted that proxy circulars were generally not providing any disclosure regarding the board's role or process for scrutinizing and vetting the measures provided by management and, more specifically, any proposed adjustments.

The following are examples of discretionary adjustments that we observed being made to GAAP figures (such as net income) in order to arrive at figures (such as adjusted net income) used to assess management performance and determine compensation awards. We are not suggesting that the following adjustments are inappropriate in all cases but rather we believe that it is incumbent upon boards to clearly communicate additional details, including why such adjustments are appropriate for compensation purposes:

- Special charges
- Other costs
- Non-recurring items
- Items not representing underlying business performance
- Unusual items
- Impairment or restructuring charges
- Acquisition-related costs

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- Equity-based compensation

In some cases, the stated rationale for making adjustments may be contentious. For example, in the case of impairment or restructuring charges, a generic justification is often provided to the effect that these charges do not reflect the underlying economic or ongoing earnings potential of the company. Some investors would question whether this reasoning automatically justifies that a management team should not be held accountable for business decisions that turned out to be unsuccessful and prompted the need for these charges. Similarly, some investors would question the practice of adjusting for equity-based compensation awards, implying that they do not represent a real cost to the company.

In addition to disclosure gaps related to the board's rationale for certain adjustments, in some cases we also noted substantial differences between measures that are used in the compensation scheme and non-GAAP figures for which a reconciliation is provided in the company's MD&A. This observation highlights the need, wherever possible, to include in proxy circulars a specific reconciliation of measures used in compensation to their nearest GAAP equivalent figure.

In general, a perceived lack of adequate disclosure prompted CCGG to undertake this study as a means of defining the relative prominence of this issue and, therefore, its importance to investors.

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Primary objectives of the study

The overarching objective of the study was to gauge the prominence of non-GAAP measures in executive compensation schemes of companies belonging to the S&P/TSX Composite Index. In order to guide our data collection and analysis efforts, we identified the following questions:

- How prominent are GAAP (defined below) and Non-GAAP Measures (defined below) in compensation schemes?
- Have Non-GAAP Measures generally or Adjusted Financial Measures (defined below) specifically become more prominent in compensation schemes over time?
- In instances where Adjusted Financial Measures are used in executive compensation schemes, are the defined parameters for calculating these measures broad or specific?
- To the extent measures are subject to potential adjustment, what has been the recent history in terms of the magnitude and directional trend of adjustments made to GAAP Measures in order to arrive at the Adjusted Financial Measures used in executive compensation schemes?
- Do proxy circulars comment on board rationale for approving material adjustments to GAAP Measures?

METHODOLOGY AND DEFINITIONS

Sample selection

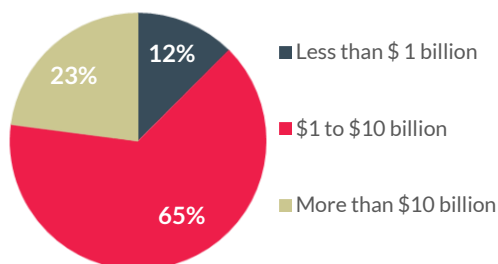
We selected 100 representative companies, which were part of the TSX Composite Index on January 9, 2019, based on the following criteria:

- Representative companies should be listed on the TSX for at least 5 years and should have been part of the TSX Composite Index for multiple (ideally 5) years prior to January 9, 2019,
- Representative companies collectively should, to the extent possible, approximate the sector breakdown of the TSX Composite Index as at January 9, 2019, and
- Representative companies should include small (less than \$1 billion), mid (between \$1 and \$10 billion) and large (greater than \$10 billion) cap companies.

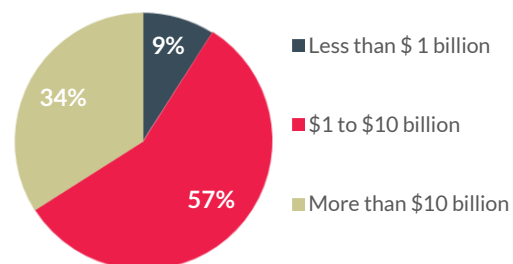
For all 100 companies, we reviewed management information circulars and annual reports that were published in calendar years 2018, 2017, 2016, 2015 and 2014. Note that proxy circulars issued between 2014 and 2018 discuss compensation awarded between 2013 and 2017.

The following charts compare the 100 representative companies (“CCGG 100”) to the S&P/TSX Composite Index as at January 9, 2019. The Composite Index included 240 companies as at January 9, 2019.

TSX INDEX
(MARKET CAP BREAKDOWN)



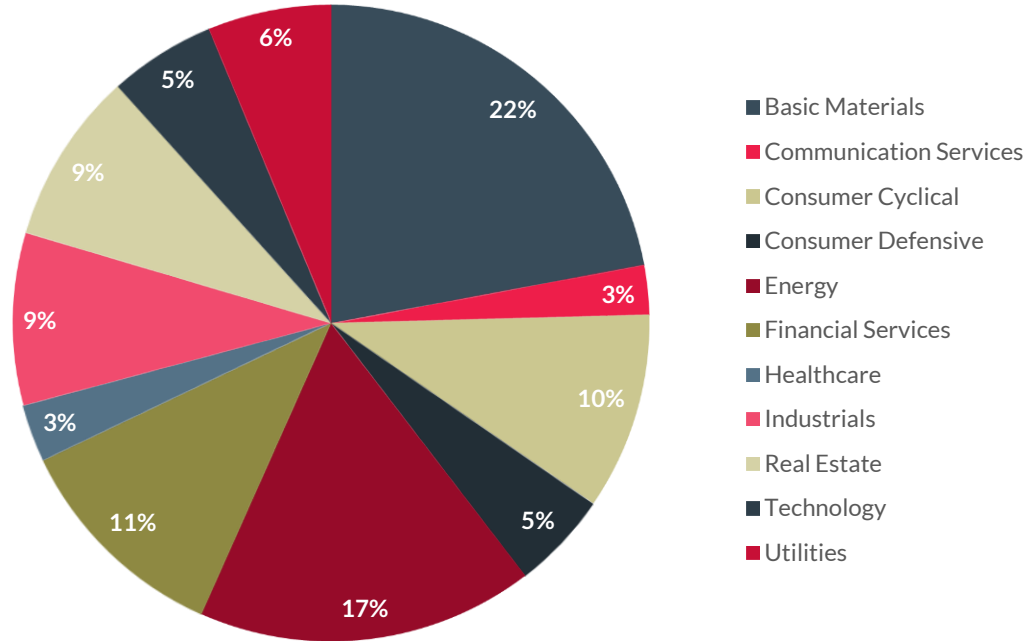
CCGG 100
(MARKET CAP BREAKDOWN)



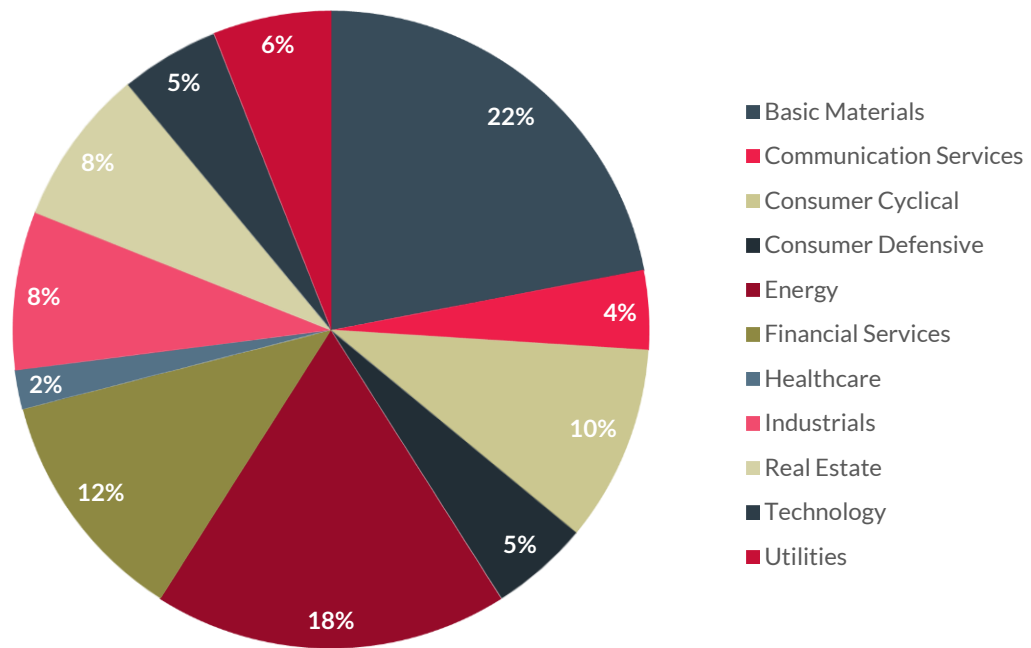
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TSX INDEX (SECTOR BREAKDOWN)



CCGG 100 (SECTOR BREAKDOWN)



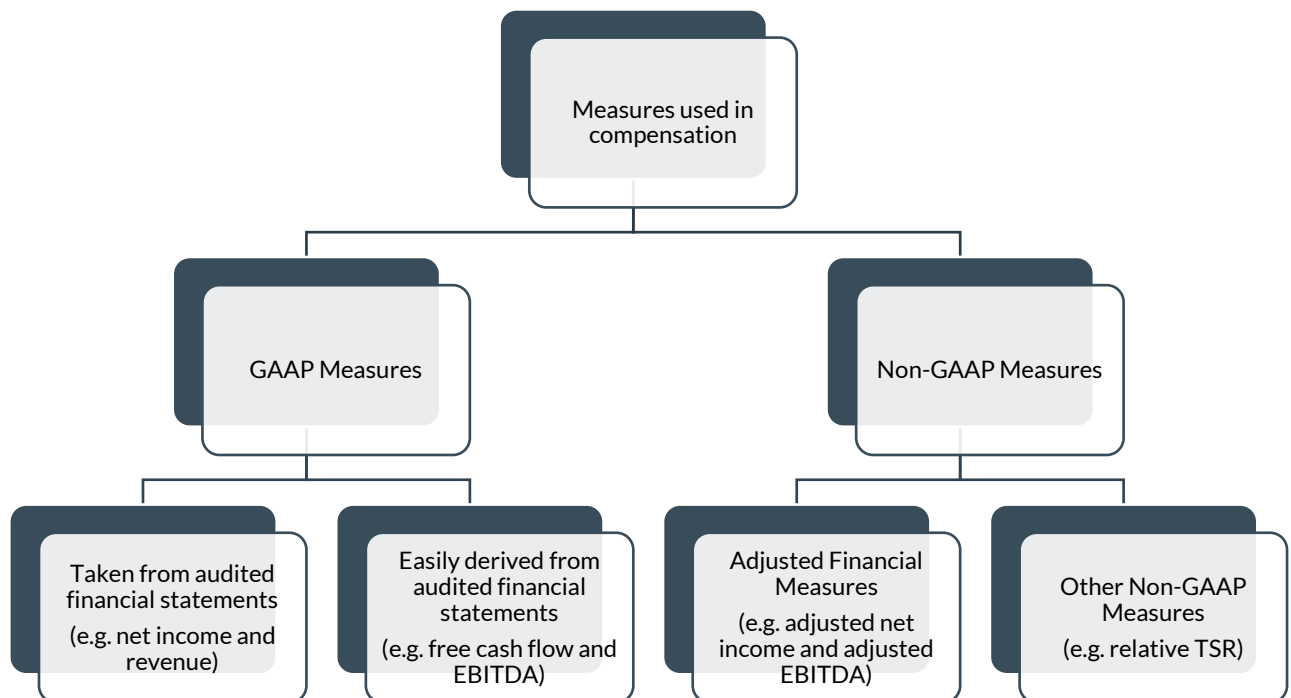
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Definitions

For the purposes of our study, we defined **GAAP Measures** as measures that are either taken directly from the company's audited financial statements or are easily derived from audited financial statements by, for instance, calculating the difference between two line items reported in the audited financial statements. An example of the latter is free cash flow, which is commonly calculated as the difference between cash flow from operations and capital expenditures, both of which are reported on the cash flow statement.

Non-GAAP Measures are defined to include: (I) **Adjusted Financial Measures** (e.g. adjusted net income) which have been determined by applying discretionary adjustments to GAAP Measures (as defined above), and (II) **Other Non-GAAP Measures** – other financial and non-financial measures (most notably, relative total shareholder return or relative TSR) for which there are no comparable GAAP Measures.

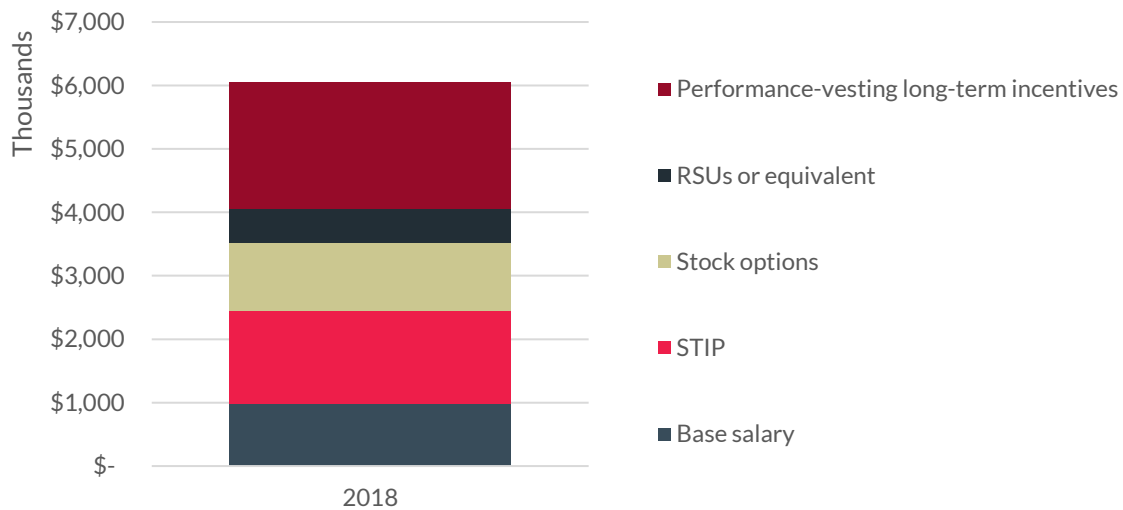


ANALYSIS AND INTERPRETATION OF FINDINGS

CEO compensation breakdown

As set out below (chart 1), average CEO compensation in 2018 at companies included in the CCGG 100 index equalled approximately \$6 million. Most of this compensation was awarded through a combination of short-term incentive plan (STIP) and long-term incentive plan (LTIP) awards, including awards that vest over time such as stock options or restricted share units (RSUs), and awards that vest based on performance (e.g. performance share units or PSUs).

Chart 1: Average CEO Direct Compensation



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Prevalence of Non-GAAP Measures in incentive compensation plans

While Non-GAAP Measures are prominent in short term incentive plans, our review did not reveal a material change in their use (chart 2). We did, however, observe an increase in the use of Non-GAAP Measures in long-term incentive plans (chart 3). This latter increase was primarily driven by companies introducing performance-vesting awards.

Chart 2: Are Non-GAAP Measures used in STIPs?

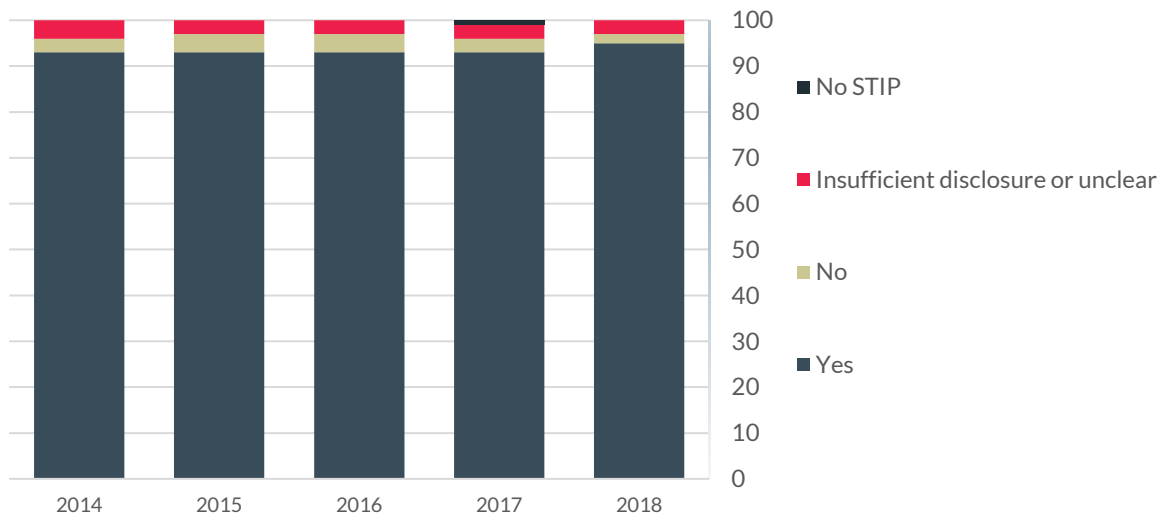
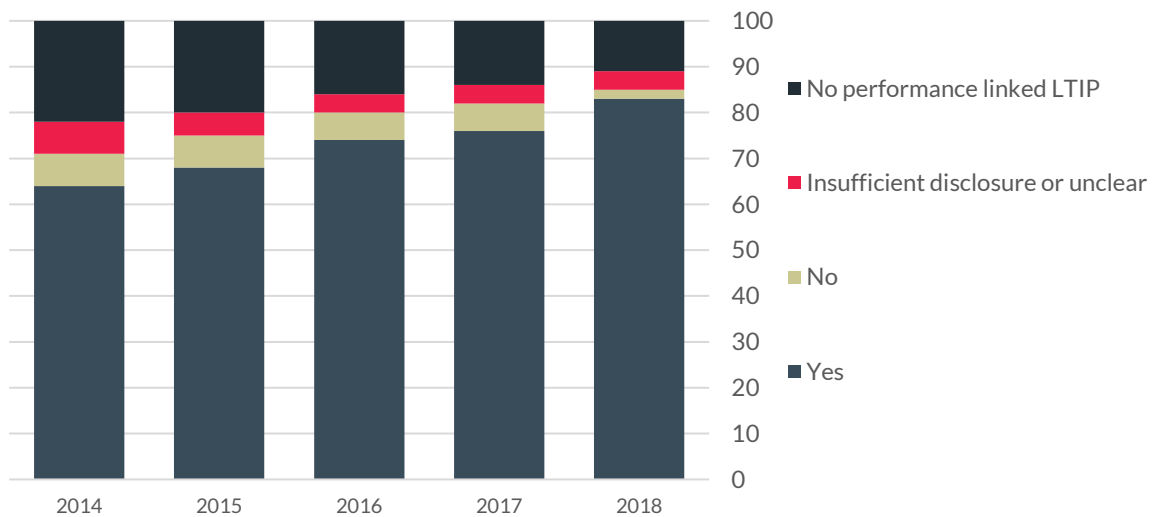


Chart 3: Are Non-GAAP Measures used in LTIPs?



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Prevalence of Adjusted Financial Measures in incentive compensation plans

While Adjusted Financial Measures are prominent in short term incentive plans, we observed only a modest increase in their use over our review period (chart 4). The use of Adjusted Financial Measures in long-term incentive plans (chart 5) increased over our review period, as more companies introduced performance-vesting awards.

Chart 4: Are AFMs used in STIPs?

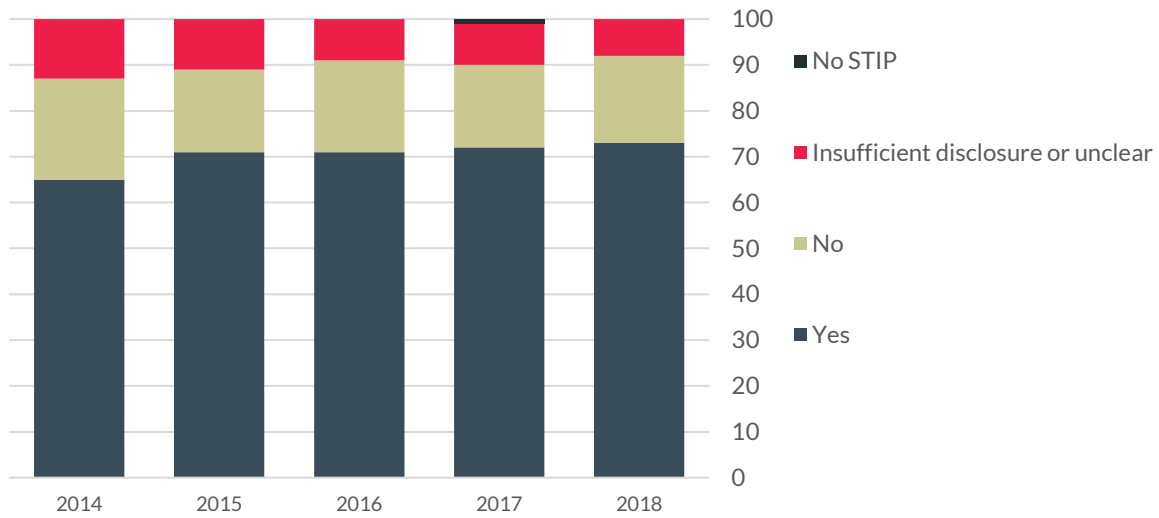
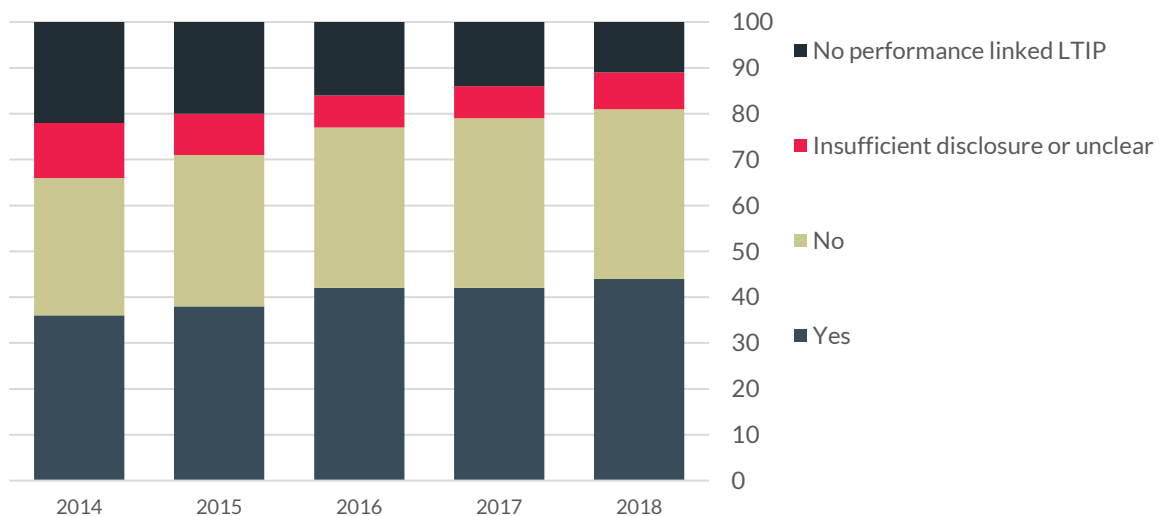


Chart 5: Are AFMs used in LTIPs?



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Primary Determinants of incentive compensation plans

Adjusted Financial Measures (AFMs) are frequently used as Primary Determinants of short-term incentive plans (chart 6) and long-term incentive plans (chart 7). We defined a Primary Determinant as a measure or a set of measures receiving the highest weighting in the determination of the award.

Chart 6: Primary Determinant of STIP

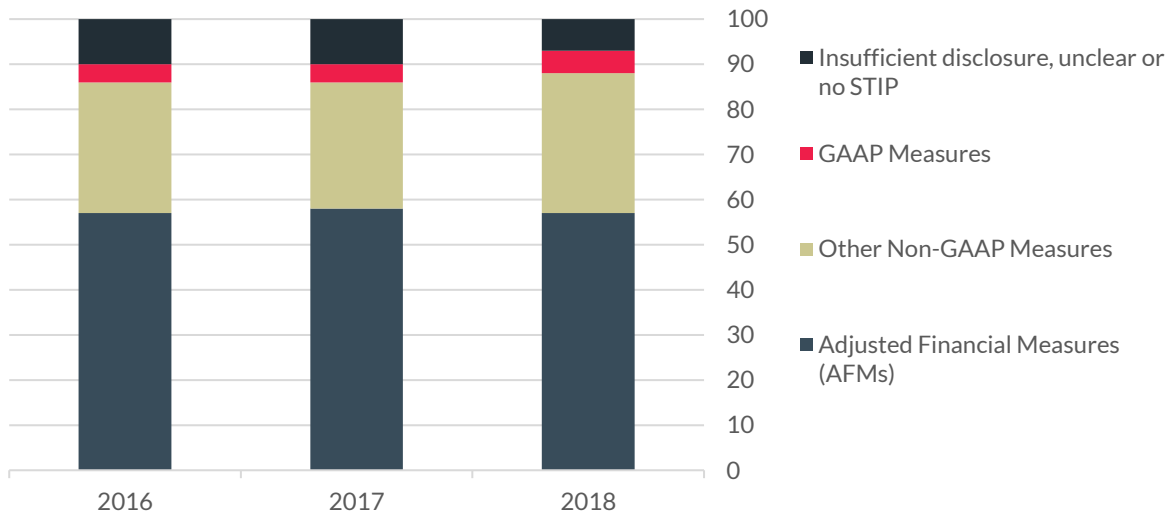
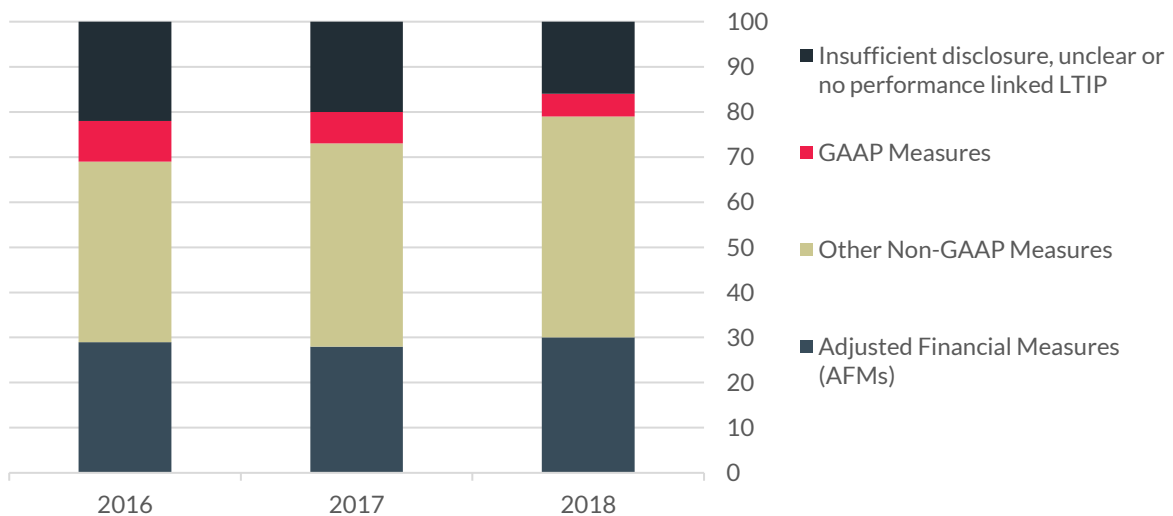


Chart 7: Primary Determinant of LTIP



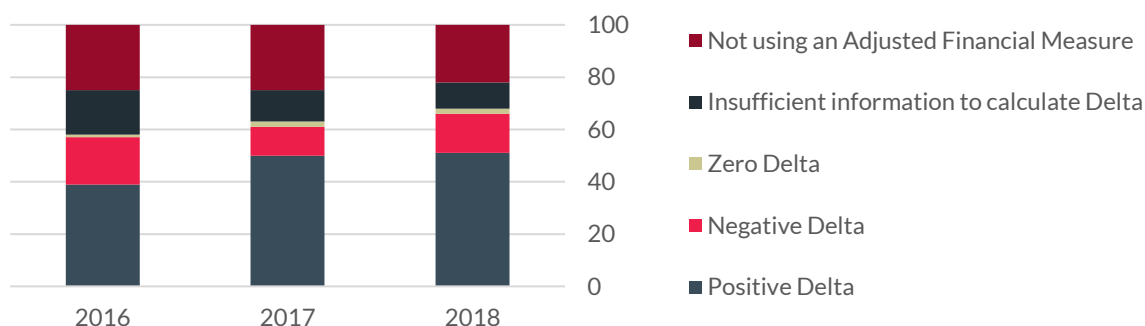
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Magnitude and direction of adjustments made to GAAP Measures

We calculated the Delta¹ between the most prominent Adjusted Financial Measure, if any, used in the compensation scheme and the most comparable unadjusted GAAP Measure. Between 2016 and 2018, we observed a significantly higher incidence (chart 8) of positive Deltas than negative Deltas, indicating that more companies are making adjustments that improve their results and this, accordingly, leads to higher compensation awards.

Chart 8: Direction of Adjustments
(Most Prominent AFM used by Each Company)



Quantum of Adjustments (Most Prominent AFM used by Each Company)	2016	2017	2018
Average	+177.2%	+113.5%	+27.9%
Median	+4.7%	+5.4%	+5.0%

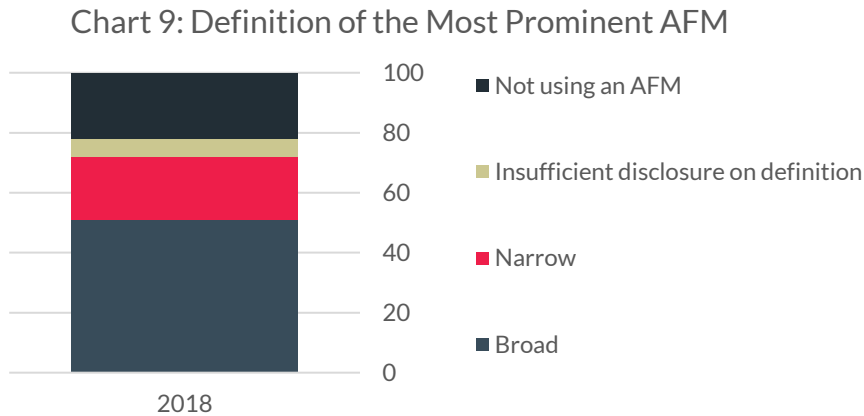
Of note, while a median adjustment of +5% may appear to be modest in absolute terms, consider the following example. In 2018, one of the two² median companies in our study utilized Adjusted Operating Profit as the primary determinant in its STIP program and its LTIP program. For the STIP, the difference between the threshold performance value for Adjusted Operating Profit (below which no payout is made) and the target performance value (at which 100% payout occurs) was 5.3%. In this instance, a 5% adjustment resulted in 100% achievement of the weighting assigned to this financial measure.

¹ We define **Delta** as the difference between the Adjusted Financial Measure reported in the compensation scheme and the equivalent unadjusted GAAP Measure. A positive Delta implies that an Adjusted Financial Measure presents a better picture relative to the most comparable unadjusted GAAP Measure.

² The other median company does not disclose sufficient detail for compensation targets.

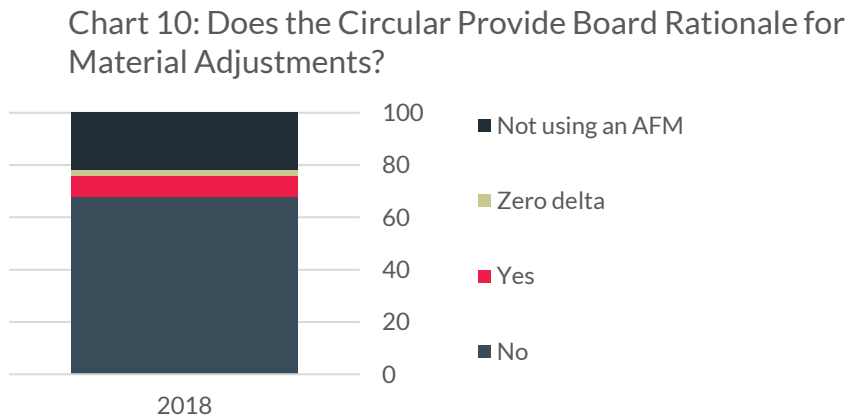
Definition of Adjusted Financial Measures

We observed that the definitions of Adjusted Financial Measures used in compensation schemes are often (chart 9) quite broad³ and allow for significant discretion.



Board rationale for making material adjustments

We also observed that proxy circulars are not providing board rationale for approving material adjustments (chart 10).



³ We classify an Adjusted Financial Measure (AFM) as “broad” when the *definition* of the measure explicitly allows for the adjustment of one or more of the following: (i) special charges, (ii) restructuring costs, (iii) other costs, (iv) non-recurring items, (v) items not representing underlying business performance, or (vi) unusual items. On the other hand, we classify an AFM as “narrow” if the definition allows for the adjustment of very specific items such as foreign exchange gains or losses.

CONCLUSIONS

We believe the analysis clearly confirms that the use of Non-GAAP Measures or Adjusted Financial Measures (AFMs) in executive compensation schemes among Canadian public companies is extensive. Furthermore, performance under these measures is significantly impacting the total amount of compensation being paid to senior management teams (generally, more so than any other measure). While we reiterate our earlier remarks that the use of these measures in compensation schemes is not inherently inappropriate, their presence and the apparent reliance placed on them by boards necessitates additional disclosure in order for investors to fully understand the executive compensation decision making process. For companies that significantly incorporate Non-GAAP Measures in their executive compensation schemes, CCGG encourages boards to ensure that related proxy circular disclosure is comprehensive and includes the following:

- a. An acknowledgement of the board's responsibility for vetting Non-GAAP Measures and scrutinizing any adjustments proposed by management, along with a discussion of the process involved in doing so,
- b. An explanation of the parameters used by the board to determine the appropriateness of individual adjustments and rationale for any material adjustments made in the previous year,
- c. Clear definitions of all Non-GAAP Measures used,
- d. Where applicable, a detailed reconciliation of Non-GAAP Measures to the closest GAAP Measure and some context regarding the magnitude and trend of adjustments historically approved by the board,
- e. Confirmation as to the year-over-year consistency in calculation of Non-GAAP Measures or, alternatively, disclosure of changes made to calculation methodology, along with a rationale for such changes and their implications in terms of year-over-year comparability of performance measures, and
- f. While not intended as a proxy for board accountability, the potential involvement of independent third parties in the review process may be beneficial (for example, in ensuring year-over-year consistency in the calculation of key metrics). Boards should report on any such involvement by independent third parties.