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## How Exclusion of Recurring Expense Items are Related to the Remuneration of CEOs

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### Abstract

This study examines the remuneration of CEOs impact the decision of excluding recurring expense items in disclosures of non-GAAP financial information by large mining companies in Australia. The results support the context of Australia which is different in terms of the remuneration structure. Short-term incentives are negatively related with the exclusion of recurring expense items in non-GAAP metrics disclosures. The two separate models demonstrate that individual component needs to be considered to get comprehensive insight of the relationship because total remuneration is not statistically significant to the exclusion of recurring expense items.

**Keywords:** Expense; Remuneration; Mining.

### 1. Introduction

Unlike remuneration package of CEOs in the US, pay structures of CEOs are significantly different in Australia [19]. The findings of the study by [19] suggest that one-third companies in Australia offer cash and rest of them belong to equity group. Moreover, another study by [21] examines that the cash or fixed component is higher for the larger companies and the senior positions in Australia. Since fixed element is substantial in pay structure of executives with the growing trend of equity-based compensation, the Productivity Commission in Australia undertook an inquiry into remuneration of executives and directors in 2009. This inquiry report indicates the major two trends (the base or the fixed pay and the incentive pay: STI-Short-term Incentive and LTI-Long-term Incentive) in the structure of executives remuneration in Australia [3].

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Moreover, this inquiry report reveals that fixed component for the large companies is comparatively smaller than those of small companies while the incentive payment is bigger for the large companies than those of small companies in Australia.

### **1.2 Research Questions and Objectives**

The motivation of this study is intended to accomplish the gap in the literature by providing empirical evidence of direct relationship between the remuneration of CEO and the non-GAAP disclosures. Further, this study takes the prospect to investigate the remuneration structure in Australia which significantly differs from the remuneration structures prevail in the US and the Europe to justify the validity of prior studies.

Essentially, this study considers the following research objectives: the following research questions will be investigated specifically:

1. RQ1: Is there any relationship between the remuneration of CEOs and the decision of voluntary disclosures of non-GAAP financial information?
2. RQ2: How does the individual component of remuneration structure of CEOs impact on the decision of voluntary disclosures of non-GAAP financial information?

The objective of this study is to examine the direct relationship between the remuneration of CEOs and the disclosures of non-GAAP financial information by the Australian companies. More explicitly, how the remuneration of CEOs impact the decision of voluntarily disclosures of non-GAAP financial information in large mining companies in Australia. In addition, this empirical research investigates a comprehensive representation considering the individual component of remuneration structure of CEO since the remuneration structure in Australia is significantly different from the US and the Europe [19]. In this context, firstly, this examination considers the fixed component of remuneration to assess the impact on the disclosures of non-GAAP information. Secondly, this study examines the incentive components: Short-term Incentive (STI) and the Long-term Incentive (LTI) of remuneration structure to measure the influence on disclosures of non-GAAP information. Essentially, this study considers the following research objectives:

1. To examine the direct relationship between the remuneration of CEOs and the voluntary disclosures of non-GAAP financial information.
2. To examine the impact of the fixed component of remuneration structure of CEOs on the decision of voluntary disclosures of non-GAAP financial information.
3. To examine the impact of the incentive components (STI and LTI) of remuneration structure of CEOs on the decision of voluntary disclosures of non-GAAP financial information.

### **1.3 Research Model and Hypotheses Development**

#### **1.3.1 Non-GAAP**

The literature in the non-GAAP financial information reveals that companies use a number of terms to disclose non-GAAP information.

Moreover, there is a variation of descriptors of non-GAAP disclosure among countries. In the USA, for example, authors in reference [17] use the key-terms that include pro forms earnings, pro forma net income/loss, adjusted earnings, and adjusted net income/loss to search non-GAAP earnings. In the similar area of non-GAAP disclosures study, [6] use the keywords that include pro forma, pro-forma and proforma. Moreover, their study uses a search string for other nomenclatures that include earnings excluding, net income excluding, adjusted net income, adjusted loss, cash earnings, earnings before, free cash flow, normalized EPS, normalized earnings, recurring earnings, distributable cash flow, GAAP one-time adjusted, GAAP adjusted and cash loss. In fact, this search string is developed by authors in reference [25] to categorize the nomenclatures used by companies to disclose non-GAAP disclosures. In assessing the non-GAAP financial measures, authors in reference [18] categories that the non-GAAP financial measures in three categories. The first group includes non-GAAP income measures/operating earnings or EBIT\_DA/cash flow or cash earnings. The second category includes non-GAAP earnings per share/earnings from continuing operation, per share, non-GAAP operating earnings, per share, non-GAAP cash earnings, per share, non-GAAP cash flow, per share. The third category includes non-GAAP aggregated disclosures which are non-GAAP net income, non-GAAP income from continuing operations, non-GAAP operating income, non-GAAP cash earnings, non-GAAP cash flow and EBIT\_DA. Further study provides with a number of non-GAAP descriptors that include EPS excluding various items, ongoing earnings, underlying earnings, adjusted net income and core EPS.

In adding further evidence, authors in reference [15] analyzed the non-GAAP disclosure practices in 20 European countries and the findings reveals the keywords related to non-GAAP disclosures are EBIT, adjusted EBIT, EBITDA and adjusted EBITDA. In the study of 50 largest (by market capitalization) non-mining Australian companies [12] provide with various non-GAAP disclosure metrics that include EBIT, EBITDA, variants of NPAT excluding, underlying earnings and normalized earnings. Moreover, in the study of non-GAAP earnings reporting by Australian banks, [20] reveal types of non-GAAP terminology that includes variation of few other non-GAAP terms.

Authors in reference [20] analyze the profit announcement and identify the terminology that include earnings and a number of derivative ratios and other non-GAAP performance measures i.e., cash earnings/profit after tax, cash profit before provisions, operating profit after tax excluding significant transactions, profit after tax excluding significant/non-core items, underlying profit after tax, cash earnings excluding conduit costs, cash basis revenue growth, core earnings, cash earnings per share, underlying earnings per share, earning per share excluding goodwill, cash return on equity, underlying return on equity, underlying cash earnings to average ordinary equity, cash earnings on average full time employees (FTE), cash dividend payout ratio, underlying cash dividend payout ratio, cash dividend cover, cash expenses to income, underlying expenses to income, cash earnings on average assets, cash expenses to funds under administration (FUA), underlying expenses to FUA, cash expenses to average in force premiums, underlying expenses to average in force premiums, economic value added (EVA) and economic profit.

Manager states non-GAAP metrics to expose underlying performance which is considered value relevant to the stakeholders in future [25].

The regulation G (a set of rules by which companies are required to present a comparable GAAP measures and reconciliation for non-GAAP measures) was adopted by the US Securities and Exchange Commission in 2003 in response to a number of corporate scandals to put investors' confidence on the information provided by the companies. Evidence indicates that prior to the regulation G, investors were misled by the firms those had weaker corporate control and governance [16]. Further research finds that there is no apparent evidence of misleading by the non-GAAP measurements [16, 20]. The study undertaken by authors in reference [6, 8] indicate that exclusion of non-recurring items does not provide with misleading information but non-GAAP information is misleading when managers exclude recurring items, for example restructuring and stock issuance cost. Further, the study of reference [2] argues that users with non-GAAP information are better off in terms of higher profit forecast than who have only the GAAP information.

Further research in non-GAAP reporting shows an increasing dependence on non-GAAP financial information by the various stakeholders including managers, security analysts, investors and the press [10]. Moreover, the insight of market participants regarding non-GAAP earnings is to be more value laden to non-GAAP earnings than GAAP operating earnings [6]. In the calculation of non-GAAP figures, managers and executives of companies make decision to include (exclude) recurring or non-recurring items with a view to conveying the underlying performance of the company to the stakeholders [6, 10, 11]. However, non-GAAP disclosures may mislead the investors when managers present information opportunistically to manipulate investors' perceptions [9, 17].

In 2011 Australian Securities and Investments Commission (ASIC), the regulator in Australia's corporate, markets and financial services, has published the Regulatory Guide 230 (guidance on the use of financial information in financial report where those information is presented not by complying with accounting standards) in which the term non-IFRS has been adopted to represent non-GAAP [4]. In Australia, the studies shows that large organizations prefer to disclose non-GAAP information more significantly. In addition, the most common disclosed metrics are Earnings before Interest and Taxes (EBIT)/Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA), Net Profit after Tax (NPAT), underlying earnings and normalized earnings [12].

In the previous studies to find the non-GAAP earnings measures conducted by [6, 16, 17] analyze press releases to search the terms of non-GAAP earnings. Further investigations by [8, 14, 18] reveal the analysis of earnings press release to locate the non-GAAP earnings and the keywords for them. To incorporate international evidence, authors in reference [15] investigate the annual earnings announcements to find the non-GAAP earnings and related terms in 20 European countries. In Australia authors in reference [20] investigate the full-year profit announcements to find the non-GAAP profit measure and the related terms. In a broader scale of sample, authors in reference [12] analyze the annual reports and the findings confirm the narrative sections of the annual reports disclose the related non-GAAP earnings terms.

Moreover, ASIC publishes the Regulatory Guide (RG) 230 in 2011 to provide with the guidelines for the types of documents to disclose the non-IFRS financial information.

Apart from the notes to the financial reports and market announcements, the RG 230 incorporates a number of other probable documents in which non-IFRS profit information can be disclosed. For example, directors' report, presentation to investors and briefings to analysts.

The previous studies in the resource sector in Australia reveal the importance of the mining sector. The prior studies reveal that mining has always played a vital role in the Australian economy by contributing around a half of all export in terms of value. Moreover, these studies acknowledge the role of mining in the Australian economy and societies have gained increasing public scrutiny in recent years.

CEO is the responsible person for the performance of the company to the BOD who oversees the activities of CEO instead of participating in day-to-day operation. Moreover, CEO sets the direction with managers who facilitate the execution of business operations under the ultimate supervision of CEO to implement business strategies. Ultimately, the CEO plays the crucial role to formulate all financial decisions that result in the outcome of the company. Hence it is more practical to investigate the influence of CEO's remuneration on the non-GAAP disclosures than that of managers and BOD.

### ***1.3.2 Hypothesis Development***

When compensation is based on performance there is a higher chance of using non-GAAP information opportunistically in the press release. Moreover, performance based compensation influences not to present adjustment for the reconciliation purpose with GAAP measurements and investors are not in the situation of proper reconciliation [15]. Prior research shows that capital market reacts to the disclosure of non-GAAP earnings. Hence the entities may involve disclosing non-GAAP information strategically to manipulate the stock price. Since incentives are related to the performance of the entities, managers and directors reap more compensation opportunistically. It was also identified by the prior studies that even controlling other factors which influence the voluntary disclosure there is a higher tendency of disclosure of non-GAAP information if incentives are associated with performance [17]. Further, [1] argues that non-GAAP information in the press release does not affect sophisticated investors but less sophisticated investors rely on press release. As a result, non-GAAP information could be misleading to some extent to the less sophisticated investors.

Prior study suggests that though compensation contracts of managers are not usually connected to non-GAAP financial information; those can influence managers to focus on either short-term or long-term vision. Moreover, if managers adopt long-term vision, the non-GAAP financial information is not used for opportunistic reason but they possibly engage in opportunistic intention with short-term vision. In the similar research stream, the study of reference [15] finds that market performance-based compensation contracts of board of directors lead to higher level of non-GAAP disclosures with more importance in press release and managers are less likely to provide reconciliations. None of the study conducted by authors in reference [15] in the Europe focused on the direct relationship between the compensation contracts of CEOs and the disclosures of non-GAAP financial information. The purpose of this study is to investigate the relationship between the compensation contracts of CEOs and the disclosures of non-GAAP financial information in Australian context.

Firstly, this study examines the impact of CEOs remuneration considering the base and Short-term Incentive (STI) components on non-GAAP information disclosures. This examination considers a negative relationship among the components. Therefore, the first hypothesis is as follows:

**H1: The possibility of excluding recurring expense items is negatively related to the incentives (short-term incentives and long-term incentives) of CEOs of the companies.**

This study investigates the direct relationships among pay-behaviors of CEOs in the context of Australia for several underlying reasons. Firstly, the interests of executives and shareholders are aligned with the compensation package and as a result it reduces opportunism and risk aversion of executives [13]. Secondly, somewhat misleading results can be avoided by analyzing direct relationships of pay-behaviors rather than that of pay-performance which results in equivocal outcomes because actions of executives drives the performance of the company [23].

Further, unlike remuneration package of CEOs in the US, pay structures of CEOs are significantly different in Australia [19]. The findings of the study by [19] suggest that one-third companies in Australia offer cash and rest of them belong to equity group. Moreover, another study by authors in reference [21] examines that the cash component is higher for the larger companies and the senior positions in Australia. Since cash element is substantial in pay structure of executives with the growing trend of equity-based compensation, the Productivity Commission in Australia undertook an inquiry into remuneration of executives and directors in 2009. This inquiry report indicates the three (base, STI-Short-term Incentive and LTI-Long-term Incentive) major trends in the structure of executives remuneration in Australia [3]. To get a comprehensive representation, this study is intended to consider all three major components of remuneration structure of CEOs to examine the influence on the non-GAAP financial information disclosures.

Secondly, this study examines the impact of CEOs remuneration considering the fixed component on non-GAAP information disclosures. This examination considers a positive relationship between the components. Therefore, the second hypothesis is as follows:

**H2: The possibility of excluding recurring expense items is positively related to the fixed pay of CEOs of the companies.**

## **2. Materials and Methods**

### **2.1 Research Model**

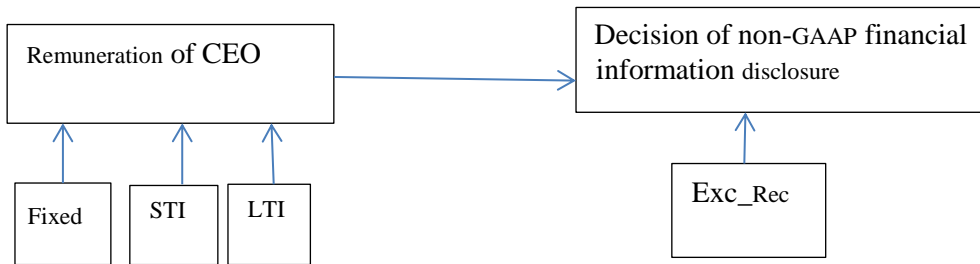
1. Independent variables:

Remuneration of CEO comprises with:

- i) Fixed pay (Fixed)
- ii) Short-term Incentive (STI)

- iii) Long-term Incentive (LTI)
- 2. Dependent variables:
  - i) Exclusion of recurring items (Exc\_Rec)

Based on the hypothesis, the research model is as follows:



**Figure 1:** Research Model

### 2.2 Sample and data

This study considers the companies which fall under the definition of mining defined by The Australian and New Zealand Standard Industrial Classification (ANZSIC) and then locate these companies in the S&P/ASX 50 index. These selection criteria results in 12 companies including 3 sectors (materials, energy and utilities) in the S&P/ASX 50.

Due to the selection criteria of wider types of documents, this investigation results in a smaller observations of 36 analyzing the result for announcement to the market, directors’ report, notes to the financial statements and management discussion and analysis for 2010 to 2012.

The remuneration data of CEOs will be collected from the SIRCA (Securities Industry Research Centre of Asia Pacific). Non-GAAP information will be hand-collect data from the result for announcement to the market, directors’ report, notes to the financial statements and management discussion and analysis collected from SIRCA (Securities Industry Research Centre of Asia Pacific) database.

### 2.3 Variable measurement

The hypotheses measure the effect of remuneration of CEOs on the decision of disclosure of non-GAAP financial information. This relationship is investigated by the following common model:

$$f(x) = \text{Remuneration structure of CEOs} \tag{1}$$

Where  $x$ =Non-GAAP financial information disclosure decision, the dependent variable. The literature of measuring the impact of remuneration of executives on non-GAAP disclosures suggests that a number of proxies have been used to measure the non-GAAP disclosures decisions. For example, the study conducted by authors in reference [7] suggests three proxies to measure opportunism in reporting non-GAAP information. These proxies include the exclusion of recurring expenses, the use of non-GAAP exclusions to convert a GAAP operating loss to a non-GAAP profit and the use of non-GAAP exclusions to move a company from missing analysts' expectations calculated accordingly GAAP operating income to meet expectations which is based on non-GAAP. Further, the studies of reference [18] use the proxy of whether or not to disclose a non-GAAP earning in the EA press release in measuring regulatory impact and remuneration impact on non-GAAP disclosures respectively.

Where remuneration structure of CEOs= independent variable. This study considers the three component of remuneration package of CEOs. The base component includes fixed pay (base and entitlements i.e., superannuation and vehicle expense). STI component includes the short-term cash bonuses and LTI component includes long-term equity based payment i.e., shares, options and performance rights.

**2.3.1 Dependent variable**

This study examines the dependent variable the 'non-GAAP financial information disclosure decision' by considering proxies. The proxy includes the exclusion of recurring items, when non-GAAP amounts are presented. In doing so, the function  $f$  carries out the method of a logistic regression. Here, the exclusion of recurring item is the related indicator variable. The coding for the exclusion of recurring item is either one or zero. In the case where the entity has excluded the recurring items for example Research & Development expenses, depreciation expenses, tax-related amounts, the code for the exclusion of recurring item is one and zero otherwise.

EXC\_REC=

$$\beta_0 + \beta_1 \text{FIXED\_SAL} + \beta_2 \text{STI\_INC} + \beta_3 \text{LTI\_INC} + \beta_4 \text{TOTALPAY} + \beta_5 \text{ASSETS} + \beta_6 \text{GROWTH} + \beta_7 \text{LEVAGE} + \beta_8 \text{PROABL} + \varepsilon \dots \dots \dots (2)$$

Where:

- EXC\_REC = the exclusion of recurring items
- FIXED\_SAL = Fixed salary component of CEO scaled by total assets of the company
- STI\_INC = Short-term Incentive of CEO scaled by total assets of the company
- LTI\_INC = Long-term Incentive of CEO scaled by total assets of the company
- TOTALPAY = Total Remuneration (fixed, STI and LTI) scaled by total assets of the company



ASSETS	= total assets of the company
GROWTH	= the growth of the company (market-to-book ratio)
LEVAGE	= the leverage (debt to total assets) of the company
ROA	= profitability of the company (return on assets)

This study anticipates a priori outcome of a positive relationship between non-GAAP disclosure decision and remuneration (base and STI) and a negative relationship between non-GAAP disclosure decision and remuneration (LTI) of CEO when using proxy measures of the exclusion of recurring items.

### ***2.3.2 Independent variable***

Components of compensation structure of CEOs are the independent variable. This study investigates compensation structure of CEOs in three different components.

Firstly, this analysis examines the fixed salary component in the compensation structure of CEO. Here, fixed salary component is scaled by the total assets considering the previous evidence that shows remuneration is closely related to company size. Consequently, company size is measured by the total assets.

Secondly, this analysis examines the STI component in the compensation structure of CEO. Here, STI component is scaled by the total assets considering the previous evidence that shows remuneration is closely related to company size. Consequently, company size is measured by the total assets.

Thirdly, this analysis examines the LTI component in the compensation structure of CEO. Here, LTI component is scaled by the total assets considering the previous evidence that shows remuneration is closely related to company size. Consequently, company size is measured by the total assets.

Finally, this analysis examines the Fixed, STI and LTI component together to get TOTALPAY in the compensation structure of CEO. Here, TOTALPAY component is calculated by adding Fixed scaled by the total assets, STI scaled by the total assets and LTI scaled by the total assets.

### ***2.3.3 Control Variable***

Large companies disclose more frequently because of the higher level of public scrutiny [5]. Moreover, the study of [8] argues that the difference in firm size should be controlled by incorporating the total assets in measuring opportunism of non-GAAP disclosure. As a result, this study controls firm size by considering the natural log of total assets. In this study the control variable for total assets is LN\_TOTALASSETS.

Empirical evidence suggests that high growth companies are more likely to provide with voluntary non-GAAP disclosures [17].

The study in reference [17, 22] measures that firm’s growth by using market-to- book ratio. This study also follows the same measure to calculate the growth rate. In this study the control variable for growth firms is MARKETTOBOOK.

This study also controls the firm leverage level in measuring non-GAAP disclosure decision. The support of this control variable also comes from the empirical study that argues highly leveraged companies are more likely to provide with higher non-GAAP disclosures [17]. Moreover, authors in reference [15] consider the debt to total assets (leverage) in assessing the decision of non-GAAP disclosures. In this study the control variable for leverage is LEVERAGE.

Prior studies by authors in reference [15, 17] argue that high variability profit companies are more likely to provide with more voluntary non-GAAP disclosures. This study also considers the profit variability of companies by calculating return on assets to incorporate the control variable. In this study the control variable for earnings variability is ROA.

### 3. Results

Our analysis shows that 58% of the sample disclosed the non-GAAP metrics in the result for announcement to the market for the time period of 2010 to 2012. While 56% companies excluded recurring expenses to disclose non-GAAP metrics which have been found after reading the directors’ report, management discussion and analysis and notes to the financial statements. Moreover, this study finds that there is no companies used recurring expense items as exclusion to convert GAAP loss to non-GAAP profit. Finally 81% of total sample disclosed either reconciliation or explanation of non-GAAP metrics disclosed in the result for announcement to the market, directors’ report, management discussion and analysis and notes to the financial statements. The summary results are presented in Table 1.

**Table 1:** Summary for exclusion of recurring expense items while non-GAAP information has been disclosed by mining companies in Australia for 2010 to 2012

Year	Exclusion of Recurring Expense items
2010	67%
2011	50%
2012	50%
Average	56%

Evidence shows that fixed pay is increasing over the time period while total incentive (short-term and long-term) is decreasing over 2010 to 2012 (result presented in Table 2). The analysis also shows that although total incentive is decreasing, there is a trade-off between STI and LTI components. Evidence shows that while LTI is increasing over the time STI is decreasing in relation to the total compensation package in Australia.

**Table 2:** Represents the summary of CEO remuneration components in relation to total pay for 2010-2012 in Australia

Year	Proportion of Fixed Pay in relation to Total Pay	Proportion of STI in relation to Total Pay	Proportion of LTI in relation to Total Pay	Proportion of Total Incentive in relation to Total Pay
2010	41%	28%	31%	59%
2011	44%	21%	35%	56%
2012	48%	11%	41%	52%
Average	44%	20%	35%	56%

**3.1 Results for relationship between remuneration and exclusion of recurring expense items**

**Table 3:** Logistic regression of remuneration components and exclusion of recurring expense items in disclosures of non-GAAP information

Variables	Model 2	Model 1
Fixed		5,030 (8,668)
Ln_TotalAssets	0.484 (0.727)	0.948 (0.741)
Market-to-Book	-0.183 (0.359)	-0.196 (0.441)
Leverage	-1.484 (1.066)	-1.491 (1.375)
ROA	23.24** (11.50)	24.22** (11.77)
STI		-9,835* (5,883)
LTI		-2,431 (4,902)
TotalPay	-1,509 (1,323)	
Constant	-7.646 (17.27)	-17.74 (18.60)
Observations	36	36
Year Fixed Effect	YES	YES

Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Model 1 in Table 3 represents the results from logistic regression to analyze the relationship between individual components of remuneration and exclusion of recurring expense items when non-GAAP information has been disclosed. The result of the logistic regression shows that short-term incentives (STI) are negatively significant with exclusion of recurring expense items.

Model 2 in Table 3 represents the results from logistic regression to analyze relationship between total remuneration and exclusion of recurring expense items when non-GAAP information has been disclosed. These empirical results demonstrate that total pay is not related to the exclusion of recurring expense items.

As a result, the first hypothesis is rejected which is the possibility of disclosing non-GAAP financial information is positively related to the incentives (short-term incentives and long-term incentives) of CEOs of the companies.

#### **4. Conclusion**

The two separate models demonstrate that individual component needs to be considered to get comprehensive insight of the relationship. The results of the logit model shows that the first hypothesis is accepted ( $p < 0.1$ ) which is the possibility of disclosing non-GAAP financial information is negatively related to the incentives (short-term incentives and long-term incentives) of CEOs of the companies. However, the second hypothesis is rejected as total pay is not significant. The results also support the context of Australia which is different in terms of the remuneration structure. Although the result is different from the previous studies conducted in USA and Europe, the result is consistent with the remuneration structure of Australia.

For the researcher this result is very significant to contribute in the literature of non-GAAP metrics disclosure by providing this empirical evidence. So the evidence outside Australian context is not appropriate for Australia that non-GAAP metrics disclosure is positively related with the incentives. Rather fixed pay is positively related with the non-GAAP metrics disclosures. Like other empirical research, this study also has some limitations: small number of observations. As a result future research should focus on more samples to develop further.

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