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The generally accepted compensation principles (GACP) in good times and in bad times

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The debacles of Enron, Worldcom and others in 2001-2002 were imputed in good part to the "flexibility" of accounting norms and the artistry in their interpretation. As a result, regulators, governmental and professional, greatly tightened the Generally Accepted Accounting Principles (GAAP) to which all publicly traded companies must rigorously adhere.

Any breach of the GAAP carries severe penalties ranging from re-statement of financial accounts to jail terms.

Curiously, under the unrelenting pressure of regulators, institutional investors and, particularly, of proxy voting advisory firms (such as ISS and Glass, Lewis), the setting of executive compensation is now governed by *generally accepted compensation principles* (GACP).

As deviations from these principles do carry significant risks for board members, GACP are meticulously observed and almost universally adopted. Indeed, the strict application of GACP ensures that the say-on-pay vote will be overwhelmingly supportive and board member re-election a foregone conclusion, unless other issues crop up.

These GACP call for specific processes and rules to set executive compensation, among which the following are critical:

- a significant proportion of the compensation of senior officers should be "risk-based", i.e., it *should be linked directly to the share price*; this means that a large part of the compensation package takes the form of stock options, shares or units the value of which is linked to the share price;

- a large portion of this incentive compensation must be "earned" by achieving some targeted *financial measures;*

- this package of salary, bonus, stock options and share-related incentives is granted in different quanta every year;

- the aggregate CEO compensation must be set with reference to the CEO compensation of so-called "comparable" companies; this bench-marking group of companies is selected by the company under advisement of its compensation consultants; this process is intended to provide guidance as to the "market" value of the CEO who, if underpaid, could presumably move to another company.

These compensation practices are based on questionable assumptions and weak premises but they have become the norm. Having applied GACP strictly, faithfully, the corporation will not face much push-back or criticism for the compensation of its executives, at least not from the institutional shareholders, provided its share price has performed reasonably well, preferably better than a relevant index.

Obviously, if the firm's financial performance is mediocre, the shareholders will be able to show their displeasure by exercising their (advisory) say-on-pay voting rights, or by voting against the election of certain members of the board.

But if the company is in difficulty and must turn-around its operations, how should its management be compensated in such circumstances? Surely, the usual GACP, whatever their limits and flaws in good times, cease to apply in turnaround circumstances.

Compensation for executives in a turn-around

A company facing a turnaround situation will usually recruit several outside executives with the talent set for the job. How do you persuade senior managers to leave a position with a stable firm and take on the risks of a turnaround job with its unrelenting work under stressful conditions?

Should the newly recruited executives be less well-paid than executives in normal course companies, *especially when they are not responsible for the firm's current difficulties?* Of course not, but the form of their compensation should be adjusted to these circumstances.

What compensation program should the board of directors adopt in such a situation?

a) As cash and cash flows are critical in a turnaround, the compensation of the senior executives should involve a minimum of cash disbursements; so, no annual bonuses and no salary increases;

b) On the other hand, *when the new executives are hired*, they should be granted stock options in sufficient quantity to attract and motivate these executives; while we are opposed, in principle, to the granting of stock options, this form of compensation is inevitable in a turnaround situation; these options should only be exercisable after three years of employment with the firm; if the new management team succeeds in the turnaround operation, it will be highly compensated for their work.

c) However, the practice of adding new stock options every year to the executives' compensation should be dropped (as it should for companies not in a turnaround situation).

d) The board or its spokesperson should clearly explain that such stock options do not make use of the company's cash and *that the monetary value attributed to this form of compensation is entirely hypothetical,* based on a questionable mathematical formula. If the new executives are unsuccessful in turning the firm around, the value of these options could be zero!

e) In a turnaround context, the senior executives should not receive any units linked to the share price other than stock options.

Thus, for a turnaround, a situation which may well have social and political repercussions, the board of directors must design unique, *ad hoc*, compensation programs that are sensitive to these realities and defend these programs forcefully.

A board spokesperson, its chair, or the lead director, if the chair is conflicted, must explain the board's decisions in the media. Contrary to the practice in the United Kingdom where the chair of the board becomes the corporation's main spokesperson for all matters relating to governance, boards of directors in North America keep a low profile and stay away from the media spotlight when governance issues come up for public scrutiny. That is a mistake.

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