A PRACTITIONER'S RESEARCH: DIRECTOR REMUNERATION IN UKRAINE

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Remuneration of members of the supervisory boards in Ukrainian joint-stock companies is the most controversial issue of the corporate board practices. Despite the firm belief of the shareholders that the director remuneration is one of the most important factors influencing the board performance, there are still many companies (21 per cent) where directors are not remunerated for their work on the supervisory board.

The situation with the remuneration of the directors in Ukraine is coming to the turning point. Thus, there is a strong trend toward the point of view that the outside directors should be remunerated certainly. There are only 3 per cent of outside directors on the supervisory boards of Ukrainian companies who are not remunerated for their work. At the same time the situation around the inside directors is not clear. There are still many inside directors (23 per cent) who are not rewarded for their work on the board at all.

Despite those factors that could be negative describers of the director compensation practices in Ukraine there are certain director remuneration practices that could be freely and reliably described. These are:

- size of the remuneration;
- structure of the remuneration;
- frequency of payments;
- assessment of the director performance.

Size of the director remuneration

Size of the director remuneration in the Ukrainian joint stock companies is USD480 a year. This is an equivalent to the salary of the CEO (head of the management board of the same company) for 10 days of working at the company. Generally said, relation between annual remuneration of the supervisory board director and CEO in Ukraine is 1 to 34 (1/34). Germany provides absolutely other numbers – 1 to 15. The US companies generate slightly higher than German ones – 1 to 21. This could evidence in the favor of the undervalued role of the supervisory board and lack of the well-justified approaches to the director remuneration in Ukraine.

Size of the director remuneration depends on *the size of a company*. Thus, larger companies pay more to the directors. Thus, the average remuneration to the director at the company with annual revenues over USD100 mln. is USD890. At the same time, the average director remuneration at the company with annual revenues below USD10 mln. is USD370. As a rule, large companies pay to their directors more than smaller ones because they are controlled by large shareholders who are inclined to pay more to their representatives on the supervisory board.

The next factor influencing the size of the director remuneration is *the company performance*. The highly performing companies (profitability is over 20 per cent a year) pay more to their directors than those companies which perform not so well. At the same time it should underline the following fact. There are no highly performing companies where the director remuneration is low, i.e. all highly performing companies pay much to their directors. Although, there are low performing companies which pay to their directors much too. Thus, there are 18 per cent low performing companies where the size of the director remuneration is over USD890, i.e. higher the average remuneration at the large, highly performing companies. This is explained by the lack of monitoring by the shareholders over the process of the director remuneration setting and the subjunctive assessment of the director performance by the directors themselves.

There is a dependence of the size of the director remuneration on *the industry* where a company operates. Slightly higher remuneration is at the companies representing metallurgy, oil refinery and energy generating industries.

Explanation of such trend is the strong market performance of the companies of those industries. Those industries are export directed or they have a strategic importance for the state. That is why the size of such companies is high, and their market performance is high too.

Table 1. Dynamic of the size of the director remuneration in Ukraine

Type of companies	Size of the director remuneration in Ukraine, USD			
	1999	2001	2003	2005
Low sized	290	340	350	370
Medium sized	320	370	410	480
Large companies	360	490	640	890

Table 1 provides an excellent data on the dynamic of the size of the director remuneration in Ukrainian joint stock companies. The main conclusion to make here concerns the strengthening the segmentation of the size of the director remuneration on the size of the companies. Thus, at the end of 1999 the sizes of the director remuneration in Ukrainian companies were almost similar despite the size of the companies. During the last five years the situation changed remarkably. Large companies became to pay to their directors much larger amounts than their smaller partners and competitors. This trend could be a positive factor for development of the market for directors. Only those companies which are ready to pay more to its directors will be run by the most efficient directors. Therefore, the role of the supervisory board in corporate governance in Ukraine should be improved.

Structure of the director remuneration

In Ukraine the structure and principles of development of the director remuneration plans differ from those, which are widely used abroad.

Ukrainian companies do not use shares in a form of compensation to members of the supervisory boards although stock options could provide a direct link between the director rewards and share-price appreciation, since the payout from exercising options increase the wealth of directors with increases in stock price, i.e. market value of the company. Stock options are prohibited by legislation in Ukraine. Prohibition is applied to any form of the company's shares instruments, including long-term plans.

We distributed questionnaires among shareholders of Ukrainian companies to find out their point of view on the possible use of stock options. Those Ukrainian companies, under control of FIGs and other institutional investors would not use shares as an instrument of compensation system because it leads to spreading the structure of corporate ownership.

In those companies, where controllers are employees, shares could not be used to motivate members of the supervisory board to perform more effectively because employees are not aware about opportunities of use of shares as an instrument of compensation system. Those companies under control of executives would not use shares to improve performance of the directors because executives do not want to loose various levers (proxies, ownership rights) as a result of the stock remuneration to directors.

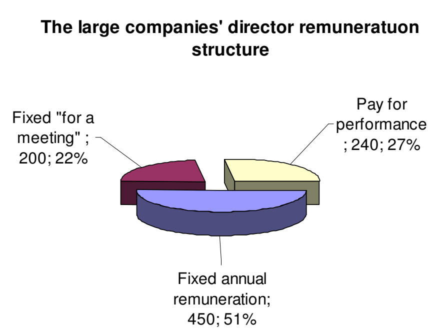

Fig. 1.a The large and small companies' director remuneration structures

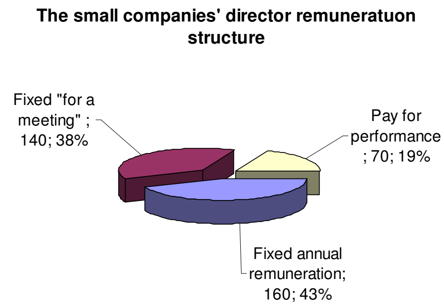

Fig. 1.b The large and small companies' director remuneration structures

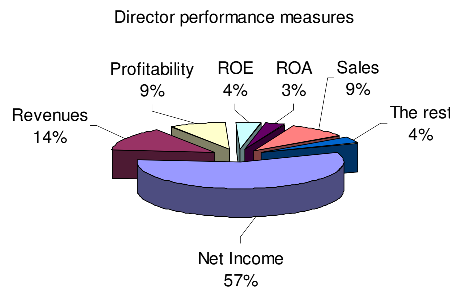

Fig. 2. Director performance measures used in Ukraine

Structure of the director remuneration in Ukraine is under transformation. Despite the size of the company the largest share of the director remuneration belongs to the fixed annual remuneration (51 per cent and 43 per cent for large and small companies respectively). At the same time there is a strong dependence of the share of the pay for performance remuneration on *the size of the company*. The larger the size of the company, the larger share of the pay for performance remuneration in the total amount of the director remuneration. The large companies rely more on the pay for performance remuneration than on the fixed for a meeting remuneration in rewarding its directors.

Fixed annual remuneration is set accordingly to the standards applied in the industry and corrected to the size of the company and its performance. Fixed annual remuneration could not be changed during a year despite the number of the supervisory board meetings the member of the board attended and his contribution (performance) in the total work of the board. All board members receive an equal fixed annual remuneration. There are only 6 per cent of Ukrainian joint stock companies where the size of the fixed annual remuneration is tied to the professional qualification and work experience of the supervisory board members.

Fixed for a meeting remuneration is paid to the director with a reference to the number of the supervisory board meetings the director attended during a year. Size of the fixed for a meeting remuneration is set similarly to the standards applied for setting the fixed annual remuneration. Therefore, the companies pay more the fixed for a meeting remuneration if they are large, highly performing and represent metallurgy, oil refinery or energy generating industries. The share of Ukrainian joint stock companies where the size of the fixed for a meeting remuneration depends on the director qualification too is extremely low. Thus, at the end of 2005 there were only 2 per cent of such companies in Ukraine.

Pay for performance remuneration is paid to the directors accordingly to their contribution to the market performance of the company. Market performance measures, as a rule, are the dynamic of the profitability, dynamic of sales and size of the net income gained during a year. Regrettably the low number of Ukrainian joint stock companies uses the pay for performance remuneration to reward their directors. At the end of 2005 there were 18 per cent of companies which used the pay for performance remuneration. At the same time there is a positive dynamic in use of the pay for performance remuneration in Ukraine. Thus, at the end of 2000 there were only 4 per cent of companies which used that form of the director remuneration.

Shareholders of Ukrainian joint stock companies have a strong wish to strengthen the role of the pay for performance remuneration in rewarding the directors. About 62 per cent of shareholders in Ukraine think that the pay for performance remuneration needs further development. At the same time only 14 per cent of shareholders were sure about the main criteria of development of the pay for performance remuneration, i.e. performance measures, performance standards[1], structure of the performance standards. These essentials for the application of the pay for performance remuneration are widely applied in developed and developing countries but Ukraine needs more time and efforts of shareholders to learn all these elements.

Performance measures. More than 80 per cent of those Ukrainian companies which reward its directors with pay for performance remuneration use a single performance measure in their remuneration plans, other companies use two or more measures. Only in a fewer cases, the multiple measures are "additive" and can essentially be treated like separate plans.

In other cases, the measures are multiplicative, in which the bonus paid on one performance measure might be increased or diminished depending on the realization of another measure.

There are no cases when bonus payments are determined by a "matrix" of performance measures. While companies use a variety of financial and non-financial performance measures, almost all companies rely on some measure of accounting profits. The Ukrainian practice of the director remuneration is still relying on a single performance measure.

Performance standards. Performance standards used for developing the director pay for performance remuneration have very narrowed application in Ukraine. The most popular is "budget" standard. Almost 92 per cent of Ukrainian companies use this standard. The most loyal to "budget" standard are employees, executives and financial-industrial groups as shareholders.

"Prior-Year" standard is popular at companies under control of foreign institutional shareholders and Ukrainian banks. "Prior-Year" standard gives a smaller space for the management speculations with numbers and following their own interests than "budget" standard. Therefore, this gives a chance that the director performance will not be distorted by the management efforts.

"Peer Group" standard belongs to the external type of standards[2]. Taking into account the fact that directors of the company have no any chance to manipulate with the performance numbers to receive more reward for themselves, "Peer Group" standard is the most appropriate to use at companies where the system of internal control is not developed enough to reward directors too. "Peer-Group" standard is more popular at companies under control of Ukrainian banks and foreign institutional shareholders.

There is a strong obstacle to use "Peer Group" standard in Ukraine. The name of this obstacle is a weak informational efficiency of the market. The Ministry of Statistics does not provide the market participants with the needful information on the industry performance. The more perspective situation in this way is in the banking where the National Bank of Ukraine has set a number of requirements to make banks disclose information about their performance. The rest industries, metallurgy and energy generating in particular, are far from the information transparency.

Despite the above mentioned problem in the development of the practice of the pay for performance director remuneration there is a growing interest of shareholders to this form of remuneration.

There is a very interesting trend to underline. Both large and small companies in Ukraine applied their efforts toward the strengthening the role of pay for performance director remuneration. In both cases the share of the fixed annual remuneration of directors decreased from 62 per cent (large companies) and 56 per cent (small companies) in 2000 to 51 per cent and 43 per cent in 2005 respectively. At the same time the share of the pay for performance director remuneration increased from 8 per cent (large companies) and 9 per cent (small companies) in 2000 to 27 per cent and 19 per cent in 2005 respectively.

Therefore it is reasonable to conclude that the size and structure of the director remuneration in the joint stock companies in Ukraine both depend on the size of companies. But the small companies are much more close to the large companies in the field of the structure of the director remuneration than in the field of the size of remuneration of directors.

[1] "Budget" standards include plans based on performance measured against the company's business plan or budget goals (such as a budgeted-net-earnings objective). "Prior-Year" standards include plans based on year-to-year growth or improvement (such as growth in sales or EPS, or improvement in operating profits). "Discretionary" standards include plans where the performance targets are set subjectively by the board of directors following a review of the company's business plan, prior-year performance, budgeted performance, or a subjective evaluation of the difficulty in achieving budgeted performance. "Peer Group" standards include plans based on performance measured relative to other companies in the industry or market (often a self-selected group of peer companies; see Section III.7 below). "Timeless Standards" include plans measuring performance relative to a fixed standard (such as an 10% return on assets, where the "10%" is constant across years, or moves in a predetermined way independent of actual performance). Finally, "Cost of Capital" refers to performance standards based on the company's cost of capital (such as a plan based on economic value added, EVA).

[2] External type of standard relates to the standards which are based on the measures of external origins (performance measures of other companies).

Table 2. Share of the pay for performance director remuneration in the total director remuneration Ukraine

Forms of the director remuneration	Large companies		Small companies	
	2000	2005	2000	2005
Fixed annual remuneration	62 %	51 %	56 %	43 %
Fixed for a meeting remuneration	30 %	22 %	35 %	38 %
Pay for performance remuneration	8 %	27 %	9 %	19 %

Frequency of payments

Frequency of payments of remuneration to the directors in Ukraine is a remuneration item that unites companies of all possible sizes and market performance. The common practices are used by all companies.

Annual fixed remuneration is paid to directors monthly. Total amount of the annual fixed remuneration to be paid to a director is divided equally for 12 months. There are only 4 per cent of Ukrainian joint stock companies where the fixed annual remuneration is paid in advance at the total annual amount.

Fixed for a meeting remuneration is paid to directors in Ukraine just after the meeting of the supervisory board or at the beginning of the month following the month when the supervisory board meeting was held. At the second case the fixed for a meeting remuneration is paid together with the appropriate (monthly) amount of the fixed annual remuneration. The first practice of the fixed for a meeting remuneration payment is applied by 84 per cent of Ukrainian companies. The second practice of the fixed for a meeting remuneration payment is used by 16 per cent of the joint stock companies in Ukraine.

Pay for performance remuneration is paid in one of two ways. The first way is used by 94 per cent of companies. According to that way the remuneration is paid to the directors at the end of the recent year or at the beginning of the next year. This depends on the efficiency of the company in preparing the required analytical reports to measure the director performance.

The second way of the pay for performance remuneration payment to the directors is used only by 6 per cent of joint stock companies in Ukraine. According to that way the remuneration is paid to the directors quarterly, i.e. at the end of the recent quarter or at the beginning of the next quarter. This way of remuneration payment is very difficult for application in Ukraine because this would ask for the strict standards in the financial reporting that is one of the most problematic aspects of corporate governance in Ukraine.

Frequency of the remuneration payments to the chairman of the supervisory board is similar to the practice applied to the ordinary members of the supervisory board at Ukrainian companies. Chairman of the board in Ukraine is paid at the end of the recent year or at the beginning of the next year if this remuneration concerns the pay for performance remuneration.

Annual fixed remuneration is paid to the chairman of the board, as a rule, monthly. Similarly to the ordinary members of the board total amount of the annual fixed remuneration to be paid to the chairman is divided equally for 12 months. There are only 5 per cent of the chairmen at Ukrainian joint stock companies where the fixed annual remuneration is paid in advance at the total annual amount.

The only practice that differs the chairman from the ordinary directors relates to the fixed for e meting remuneration. Almost all chairmen in Ukraine are paid with the fixed for a meeting remuneration just after the meeting of the supervisory board. This practice is applied to 96 per cent of chairmen of the supervisory boards at the joint stock companies in Ukraine.

Assessment of the director performance

The Ukrainian joint stock companies have much to do in the way of approaching the procedure of assessment of the director performance to the international standards and best practices. Formal assessment of the director performance procedures are still not developed in Ukraine. Only 7 per cent of companies assess the director performance through a formal performance appraisal system this is designed and applied within the supervisory board. At the same time there is a dependence of using the formal performance appraisal system on the size of the company. Thus, large companies use this approach to asses the director performance more actively than their smaller partners and competitors. There are 11 per cent of large companies which use that assessment procedure.

The most popular procedure for assessment of the director performance in Ukraine is through individual feedback from shareholders. There are 64 per cent of companies which use that procedure to evaluate the director performance. It should be noted that the higher the degree of ownership concentration the higher degree of application of that procedure by the company. Large shareholders are very active in assessing the director performance personally. There are 72 per cent of large companies which use personal approach to assessment the director performance.

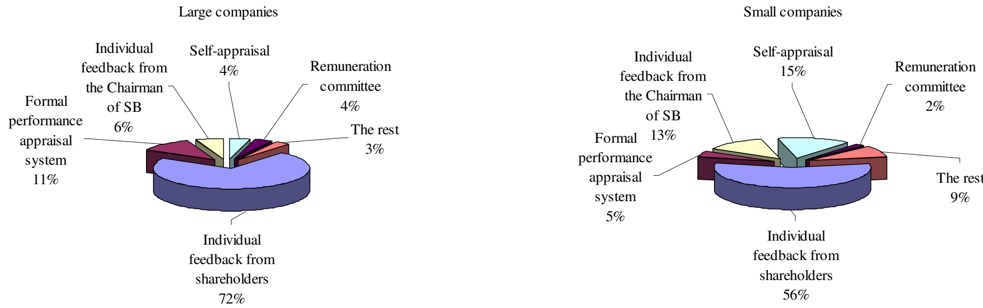

Fig. 3. Procedures for assessment the director performance in large and small companies

With reference to *fig. 3* it is reasonable to conclude that there are two different approaches used by large and small joint stock companies in Ukraine to assess the director performance.

The fist approach, applied by large companies is built around the strong role of the large shareholder and formal procedures to assess the director performance. The role of the director self-assessment and assessment by the chairman of the supervisory board is weak.

The second approach, used by small joint stock companies is about the growing role of the self-assessment by the directors and assessment by the chairman of the board. The role of the director performance assessment by shareholders themselves is relatively weaker than for the large companies.

These two approaches in the assessment of the director performance are the consequences of the privatization in Ukraine that is followed with the fight for corporate control, ignoring and violating the minority shareholder rights and low knowledge of individual minority shareholders on the best procedures in assessment of the director performance.