ВИСОКА ПОСЛОВНА ШКОЛА
СТРУКОВНИХ СТУДИЈА – БЛАЦЕ
Часопис из области економије, менаџмента и информатике *„БизИнфо“*
Број 2/2010, стр. 151 - 160
Адреса: Краља Петра I, бр.70, 18420 Блаце

BOARDS OF DIRECTORS COMPENSATION ALTERNATIVES

ALTERNATIVNI SISTEMI NAGRAĐIVANJA DIREKTORA UPRAVNOG ODBORA

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Rezime: *Direktori, članovi Upravnog Odbora, imaju dužnost da štite interese akcionara. Ipak, njihovi interesi verovatno nisu identični interesima akcionara. Kao i svi ekonomski akteri, direktori preferiraju veću zaradu, stoga se mogu motivisati upotrebom finansijskih podsticaja. Kompanije rutinski koriste razne sisteme podsticaja, uključujući nadoknadu za prisustvovanje sastancima, nagradu u akcijama i opcijama, i kratkoročne bonuse za ostvarene performanse. Pored direktne nagrade, postoje i drugi motivi koji bi mogli da utiču na aktivnosti direktora. Mogući motiv je snažna reputacija sposobnih poslovnih pojedinaca. Jaka reputacija značajna je na tržištu za osvajanje članstva u više Upravnih odbora, ili zadržavanje postojećih.*
Ključne reči: *Upravni odbor, nagrađivanje, podsticaji, akcionari*

Abstract: *Directors, members of the Boards of Directors, have a fiduciary duty to protect shareholders' interests. Yet, their interests are unlikely to be perfectly aligned with the shareholders'. Like all economic actors, directors may be presumed to prefer greater wealth to less wealth; hence, they should be responsive to financial incentives. Companies routinely use a variety of such incentives including additional fees for attending meetings, stock and option grants, and performance bonuses. Besides direct compensation, there are other motivations that could affect director behavior. A possible motive is the concern that directors have for being seen as able*

business people. A strong reputation is likely to be important in the market for getting more board seats or retaining the ones already held.
***Key words**: Board of Directors, Compensation, Incentive, Shareholders*

1. INTRODUCTION

The amount and structure of the Board of Directors compensation is not sufficiently studied area, although it is the base for management reward and the foundation of other processes and performances of the company. The careful analysis would make an important source of information for understanding the level and structure of top management compensation. In contrast to numerous studies conducted on the subject of management compensation, academics show little interest in rewarding directors and the effect of this process at the company. Lack of interest can be explained by assuming that Board of Directors, as principal-agent theory suggests, acts in accordance with the shareholders requests. However, more recent theories consider directors as agents of shareholders whose opposed interests can lead to increased agency costs. Some authors argue that the Board of Directors compensation plans, rather than a solution, are evidence of the unresolved problem of agent-principal relationship. The level and structure of the reward are influenced by various factors including company size, market conditions and type of industry. The past practice meant that most of the reward was paid in cash, while today the proportion changed in favor of stocks. In addition to compensation in cash or shares, the total award for Directors contains the different categories of benefits. This may include paid leave, paid services, health plans and life insurance, pension programs. In addition to direct award, a strong motive which influences the director's actions is their interest in gaining the reputation of capable businessmen. Concern for reputation will persuade the agents to act more in line with the principals' interests.

2. DETERMINANTS OF THE COMPENSATION SYSTEM FOR DIRECTORS

The Board of Directors is the highest governing body of the company. The Board of Directors is mandatory of the shareholders and has the authority to represent their interests. The main role of the Board is to protect the shareholders assets and provide adequate return on capital.

In some European countries, Directors believe that their primary obligation is to protect the interests of all employees, and secondly of shareholders. Board members are elected each year. The primary responsibility of the Board is the selection of the top management team, the approval of the annual business plan, and the adoption of long-term strategy. The Board is monitoring the performance of top management within the approved plans. Evaluation of the top management performance and the compensation package also are obligations of Board of Directors. These issues are concerns of a special committee, a Compensation committee.

The Board of Directors compensation practices are an important source of information for understanding the level and structure of top management awards (e.g. Yermack, 2004, Ryan and Wiggins, 2004). However, compared with numerous studies conducted on executive compensation, academics have shown little interest in remuneration of directors outsiders and the effect of this process at the company. Lack of interest can be explained by assuming that the Board of Directors and the Compensation Committee, according to the principal-agent theory, act in shareholders' best interest. According to this opinion, there are no agency costs between shareholders and members of the Board, and the incentives are irrelevant. Contrary to these views, recent theories consider directors as shareholders agents, which opposed interests can create higher agency costs. Motivational remuneration for directors, in the form of stocks or options, will direct their activities towards increasing their equity and shareholders' equity.

The National Association of Corporate Directors report (NACD - The National Association of Corporate Directors) from 2001, *"Board Evaluation: Improving Director Effectiveness"* gave a number of important proposals for improving the performance evaluation of the Board:

- Development of the evaluation process often occurs in stages, starting with general manager evaluation, the evaluation of the entire Board of Directors, the Board of Directors self evaluation, to an evaluation of competitors.
- For self evaluation, the Board must prepare a description of specific tasks and goals, and then define the method of performance measurement according to set responsibilities.

- The Board should appoint an independent commission to monitor its own operations.
- Monitoring the activities of the Board is critical to an effective evaluation process and has a purpose: to improve business performance and long-term value for shareholders.
- To be effective, evaluation should lead to a clearer understanding of the purpose of the Board as a strategic company resource.
- After the review of the evaluation results, the Board of Directors should adopt and implement the actions required for improvement in certain areas.
- Management Committee may initiate action plans with specific deadlines for implementation of the Board recommendations and for monitoring each implementation process phase.

National Association of Corporate Directors has identified five principles for remuneration of Board members in its publication from 2005, *"Director Compensation Report"*. These principles are the following:

- Remuneration of directors should be defined by the Board of Directors and presented to shareholders
- Remuneration of directors should be aligned with the long-term interests of shareholders
- Reward should motivate directors
- Directors should be adequately compensated for their time and effort
- Directors' remuneration should be considered from the broader aspect, and not based on a separate elements

The publication provided a list of six best compensation practices that should be followed by the Board of Directors:

- Establish a process of the compensation program determination in an objective manner.
- Set high requirements for share ownership of each director and the time limits for fulfilling that request.
- Define desired total value of each compensation element for directors.
- Reward executives only in the form of capital and cash. The reward in the form of capital should make 50-100% of the total compensation. Use existing compensation programs and avoid introducing new ones.

- Adopt a policy that forbids the involvement of directors, or companies in their possession, in professional or financial services performing.
- Publish in the official reports of the company philosophy and process of award determination for directors, as well as the value of each reward element.

There is evidence that directors outsiders negotiate their total reward, and that the strength of their relative power over the managers influences the amount of compensation. Ryan and Wiggins (2004) found that directors of companies whose management holds the position for a long time, or the general manager is the Chairman of the Board (which shows less powerful directors), received a lower overall reward for their efforts. Brick et al (2002) confirmed the lower level of total fees for directors in companies where the general manager has a significant portion of ownership, or the majority of Board members are the directors insiders. In contrast to the results of Ryan and Wiggins (2004), these authors believe that the dual function of general manager positively influences the amount of total reward for directors.

The company's strategy as well as financial decisions is closely linked with the structure of remuneration of directors. Yermack (2004) found that in the presence of leverage, the companies deliver a smaller part of the award in the form of capital. Yermack (2004) came to the conclusion that when paying the dividends, a company will less likely use capital-based reward. This is consistent with the view that the company rely more on rewards in the form of capital in periods of cash insufficiency. Brick et al. (2002) also defined the determinants of directors' remuneration in the form of capital. Volatility of shares, company size measured by number of employees, ***Research and Development intensity*** and the dual function of general manager, are all positively associated with the part of directors reward delivered in the form of stocks and options. At the same time, leverage is negatively associated with the reward paid in the form of capital.

4. COMPENSATION ALTERNATIVES FOR DIRECTORS OUTSIDERS

Directors of the Board who are insiders (company managers and investors) don’t have to be directly rewarded for their work. But directors outsiders generally expect some form of reward, although

this is not the main reason of their involvement. Determination of directors' awards is mainly based on remuneration of the competition, according to the maintained research surveys. Rewarding depends on various factors including company size, market stage and industrial branch. Probably the most common form of directors' compensation is a combination of annual award and a fee for every session held, thus rewarding the ongoing responsibility and the absence from work due to the meeting. Companies that pay only a fixed fee reward the director's responsibility within the Board of Directors, regardless of their active presence. Companies that pay just the meeting fee require active participation of directors and taking their opinions into the discussion. Fixed fee is similar to base pay, while the pay per meeting is the form of bonus for attendance.

Besides the award on behalf of the Board membership, most companies pay an additional fee for involvement in each of established Committees. Some companies pay an annual compensation to the presidents of the committee, as recognition of his organizational responsibilities (e.g. planning the agenda, meetings with the management, coordination of work, reviewing the recommendations).

There are more compensation elements of the Board members, including the following:

- Reimbursement of travel expenses.
- Insurance. Due to the potential legal risks associated with membership in the Board.
- Stock options. Depending on the company type, stock options may be the primary mean of compensation for board members.

In the past, rewards were mostly paid out in cash (sometimes completely), but the payment is now mainly done via restricted stocks. Usually restriction expires at the end of the engagement of directors, and postponed award reflects the change in share price during the period of their work. The company's shares should make a significant part of the total reward for directors. What will be the relationship between the portion of award in cash and the part in stocks depends on the importance given to ownership of directors.

Board of Directors may use different categories of benefits. This may include paid leave, paid services, health plans, life insurance and pension programs. When it comes to programs of paid services, it is common that directors are involved in educational/charitable programs, the plan of liability insurance, and for them travel expenses incurred for business purposes are reimbursed. Some directors are also entitled to the use of aircraft and apartments of the company, a discount on companies' products, an access to club memberships, and personal liability insurance. Also, directors may use legal and administrative services of the company, as well as free advice on tax issues and financial investments. Since the majority of directors are covered with some health insurance plans, additionally they can get some dental and medical services provided by the company plan (if they don't have that type of insurance). Life insurance is usually limited to the case of accident during the business trip. A large number of companies have a pension programs for directors outsiders. These programs used to involve a payment equal to the annual award of director, for all the years of involvement in the Board. This practice was abandoned at the shareholders request, because it promoted the length of service, not the performance.

Membership in the Board of Directors is no longer an honorary function, but a challenging work because of social responsibility and other important issues. Directors are faced with the risk of litigation if it is considered to have deliberately made decisions in its domain. Although liability insurance compensates for such losses, the individual is harmed due to legal actions and public charges of professional negligence. Bonus payments in advance when hiring the director will become necessary, especially in the case of troubled companies. Given the fact that the demand for quality directors increases, and a number of talented individuals who can perform this function decreases, it is expected that the directors' remuneration will grow significantly in the future period. It is expected that the majority of the total reward will be paid in company shares or their equivalent.

5. REPUTATIONAL CONCERNS

In addition to direct awards, the possible motive that influences the behavior of the director is the interest that they attach to their reputations of capable business individuals (e.g. Adams, Hermalin, Weisbach, 2010). The idea dates from the 1980s, when the Fama

(1980) concluded that the concern for the reputation will force the agent to act more in line with the interest of principal. Director reputation is important in business environment. A good reputation is probably helping them to win the position at several Boards of Directors, or to retain the ones he already holds. Gilson (1990) and Kaplan and Reishus (1990) investigated this possibility empirically. Their research suggests that managers who perform worse at work are less likely to be eligible for membership of the BoD at another company. Fich and Shivdasani (2007) investigated how the reputation of the directors is affected by the fact that they were members of boards at companies that participated in trials due to financial fraud. This study confirmed that the directors outsiders will not resign from the Board because of the judicial process. They, however, face significant decline in the number of Boards in which they are members. This decrease is greater if the financial fraud is more "serious", and when the directors had a greater responsibility for monitoring (prevention) of such fraud, for example, if they were members of the Audit Committee. These directors with "soiled" reputation probably will lose a place at a Board of the company with stronger corporate governance. Although these studies were significant, their value is related only to the visible reputation, they do not touch its "soft" dimension (e.g. Adams, Hermalin, Weisbach, 2010). Specifically, the director who wants to retain or to gain a place in the Board, at least theoretically, could have traded with his reputation. As these studies indicate, the director who has a public reputation as poor supervision (monitoring), loses a certain number of seats held at the various management committees. At the same time, the director whose reputation as poor monitoring was not publicly known can be very attractive to managers who want to have power over the Board of Directors.

6. CONCLUSION

Modest compensation for all directors, in equal amounts, was appropriate when the membership at the Board of Directors was more a matter of honor rather than risk. Today, corporate governance requires a different kind of reward, in accordance with the responsibilities and the risk taken. The most common form of remuneration for directors of the Board is a combination of annual award and compensation for each held session, which evaluates the ongoing accountability and absence from work due to the meeting.

Besides the award on behalf of involvement in the Board, most companies reward additionally the membership in each of the Committees. In some cases, fixed salary and the fee for the meetings held may be paid or only one of them. Some companies pay an annual compensation to the president of the committee, as recognition of organizational responsibility. There is evidence that directors outsiders negotiate their total reward, and that the strength of their relative power over the managers influences the amount of compensation.

In the past, most of the rewards were paid out in cash (sometimes the complete), but the payment is now mainly done in restricted stocks. Usually restriction expires at the end of the directors engagement, and postponed award reflects the change in share price during the period of their work. Board of Directors may use different categories of benefits. This may include paid leave, paid services, health plans, life insurance and pension programs. What benefits or perquisites are appropriate depends on the message the Board wants to send to executives and other stakeholders. If the Board of Directors receives no special benefits, the easier it will deny them the executives, and give the message that the Board is only interested in rewards that are firmly based on performance.

In addition to direct awards, the possible motive that influences the behavior of the director is the interest that they attach to their reputations of capable business individuals. Concern for reputation forces agents to act more in accordance with the interests of principals. Director's reputation is important in a business environment. A good reputation helps in obtaining positions in several Boards of Directors, or in retention of the positions director already holds.

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