# THE KOSTYUK REPORT: EXECUTIVE COMPENSATION PRACTICES IN UKRAINE

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**Abstract**

The main research question of this research is: "Does an ownership structure influence performance of executive compensation in Ukraine?". A very detailed investigation of the most active Ukrainian joint stock companies has been undertaken. Total number of the companies under research is 50. Period of investigation is from 1998 to 2003. Fixed-based compensation is still the major form to reward executives at Ukrainian companies. From this perspective, Ukrainian practices for rewarding executives belongs to Continental model, developed in Germany. It can be explained by lack of: appropriate legislation, allowing stock based compensation; liquid stock market; lack of knowledge of directors (members of supervisory boards) on incentive based compensation; lack of control and executive monitoring functions by supervisory board.

**Keywords:** executive compensation, ownership structure, supervisory board

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## 1. Introduction

One of the most important problems of corporate governance is agency costs, that should be minimized using a set of mechanisms. Fama and Jensen (1983) and Jensen and Meckling (1976) define agency costs as the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests and the value of output lost because the costs of full enforcement of contracts exceed the benefits. One way to alleviate the agency problems between shareholders and outside directors is to get to one of corporate governance mechanisms through providing outside directors with compensation packages that directly align the interests of both parties. Types of compensation include cash (e.g., annual cash retainer, fee per board meeting, and fee for chairing a committee), stock option awards, restricted stock grants, and pension plans. Each award has its benefits and drawbacks in motivating directors to act in the best interests of their shareholders. These benefits and detriments, in turn, depend on the characteristics of each firm. One of these characteristics is the firm ownership structure.

Kostyuk (2003) reported that the major groups of shareholders in Ukraine - foreign and national institutional shareholders, outside individual shareholders, employees and executives - follow different interests when governing companies. Moreover, all groups of shareholders behave in the various manner toward setting the best standards of corporate governance. Thus, foreign institutional shareholders perform much better than other groups of shareholders when establishing accountable and transparent system of corporate governance. From this perspective, an executive compensation, as one of the corporate governance mechanisms, should reflect investment and control behavior of shareholders. The main research question of this research is: "Does an ownership structure influence performance of executive compensation in Ukraine?". To answer the question above, the following methodology will be applied.

## 2. Methodology of research

A very detailed investigation of the most active Ukrainian joint stock companies has been undertaken. Total number of the companies under research is 50. Period of investigation is from 1998 to 2003. We identified the following groups of shareholders to research: foreign institutional shareholders, Ukrainian financial-industrial groups, employees. The following data sources have been used to conduct investigation:

- annual reports of Ukrainian joint stock companies;
- annual reports of the State Securities and Exchanges Commission in Ukraine;
- annual reports of the First Stock Trade System in Ukraine;
- stock market reports, developed by famous Ukrainian investment companies.

The following hypotheses should be tested:

1. Bonuses, as an element of executive compensation, are paid a particular attention at those companies under control of foreign institutional shareholders and Ukrainian financial-industrial groups.
2. Salary based executive compensation is applied the most intensively in companies under control of executives and employees.
3. In Ukraine the size of executive compensation depends strongly on a size of companies.
4. The degree of independent decision making on executive compensation is very weak

## 3. Results obtained

In Ukraine, the structure and principles of development of executive compensation plans differ from those, widely used abroad.

Ukrainian companies do not use shares in a form of compensation of members of Management Boards because it is prohibited by the Law. Therefore, in Ukraine, executive compensation can be based on cash elements or non-material (so named "social") elements.

The most traditional view on executive compensation is popular at companies under control of executives. Salary (fixed) based compensation is a heritage of a command economy. There is only one difference. Before the 1990's, i.e. the USSR destruction, executive compensation were developed by appropriate Ministries and further directed to executives of all companies under ruling of certain Ministry. At this time, at companies, under control of executives, executive compensation is developed and approved by executives themselves. Previously, it was a dictate of Communist party. Nowdays, this is a dictate of executives.

Compensation system at the companies, under control of Management is pictured below.

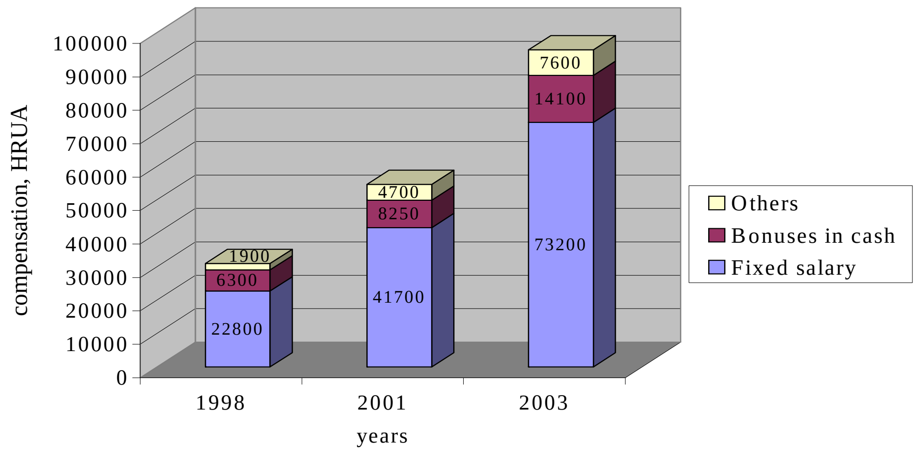


**Fig. 1.** Compensation system at Ukrainian companies, under control of Executives

With reference to the figure above, we conclude that times change but executives in Ukraine do not. During years 1998-2003 the structure of executive compensation did not change. Fixed compensation is still the major element of compensation. Moreover, we need to note that the size of compensation has increased (232 percent increase). At the same time, stock prices of these companies increased only for 28 percent, assets value increased for 14 percent, net income - 12 percent. Moreover, salary of middle-level managers increased for 69 %, employees - 48 percent.

Thus, the first hypothesis, i.e. bonuses, as an element of executives compensation, are paid a particular attention at those companies under control of foreign institutional shareholders and Ukrainian financial-industrial groups, is vital.

Executive compensation system at the companies under control of foreign investors differs from those, used by companies, controlled by executives.

Foreign shareholders come to Ukraine not only with money. They bring with them advanced knowledge and skills on modern principles of development of an efficient executive compensation system. Moreover, under a weak transparency of market for corporate executives in Ukraine, foreign institutional shareholders bear high risks when hiring executives. To minimize risks and a probability of wrong choice, foreign shareholders have to create a system of executive incentives, including executive compensation.

Thus, for year 2001 the share of bonuses in cash, paid to executives in companies under control of foreign investors in total amount of compensation is equal to 36.2 % in comparison to 15.6 % at the companies under control of executives. In 2003, the share of bonuses in cash, paid to executives at the companies under control of foreign institutional shareholders increased to 39 %.

For years 1998 and 2003, the size of executive compensation at companies, under control of foreign institutional shareholders increase from HRUA28.000 to HRUA69.000 (140 percent increase). At the same time, stock prices of these companies increased for 89 percent, assets value increased for 42 percent, net income - 51 percent. Moreover, salary of middle-level managers increased for 104 %, employees - 82 percent. Therefore, executive compensation is sensitive to performance of executives much more at companies under control of foreign institutional shareholders, than at those, controlled by executives.

Companies under control of Ukrainian financial-industrial groups are inclined to follow principles of incentive based compensation. They are going to develop a compensation system based on bonuses. At the end of 1998, the share of bonuses in cash, paid to executives in companies under control of Ukrainian financial-industrial groups in total amount of compensation was equal to 12 %. At the end of 2001, the share of bonuses in total amount of compensation got up to 25.2 %. For years 2001-2003, the share of bonuses increased to 29.6 percent.

Thus, the second hypothesis, i.e. salary based executive compensation is applied the most intensively in companies under control of executives and employees, is vital.

**Table 1.** Structure of executive compensation at the companies, controlled by various groups of shareholders

| Controllers | Structure of Executive compensation | | | |
|---|---|---|---|---|
| | salary | bonuses | options | others |
| | 2001/2003 | 2001/2003 | 2001/2003 | 2001/2003 |
| Executives | 75.9/75.6 | 15.6/15.5 | 0 | 8.5/8.9 |
| Ukrainian FIGs | 68.6/64.5 | 25.2/29.6 | 0 | 6.2/5.9 |
| Foreign investors | 58.7/57.1 | 36.2/39.0 | 0 | 5.1/3.9 |
| Employees | 80.5/79.4 | 12.3/12.9 | 0 | 7.2/7.7 |

Generally, for years 2001-2003, there are two approaches to executive compensation in Ukraine. The first is undertaken by companies under control of institutional investors - foreign institutional shareholders and Ukrainian financial-industrial groups. They constantly try to develop an incentive based compensation system.

The second approach is applied by companies under control of individuals - executives and employees. These companies prefer to use a fixed based executive compensation system. Moreover, during the period researched, these companies were not trying to change the situation. The share of base salary almost did not change.

Probably, preference to a fixed-based executive compensation in the companies under control of employees is because of origin of executives. These companies get to services of insiders, who worked in the company for a long time. From this point of view, base salary is not an incentive to make executive perform better. This is a reward for their commitment to the company, i.e. a whole life service to the company. That approach is like an approach, applied in Japan. In comparison to international practice in executive compensation, Ukrainian practice is similar to German and Japanese practices. Stock based compensation is not popular, base salary take a huge part in the total volume of compensation. From this perspective, companies (owners) reward executives for their experience and results, achieved in the past. But, in contrast to Germany and Japan, where fixed based compensation is a result of business model development and customs, fixed based compensation can be explained not only by "heritage" of the USSR dogmas of planned economy. It can be explained by lack of:

- appropriate legislation, allowing stock based compensation;
- liquid stock market;
- lack of knowledge of directors (members of supervisory boards) on incentive based compensation;
- lack of control and executive monitoring functions by supervisory board.

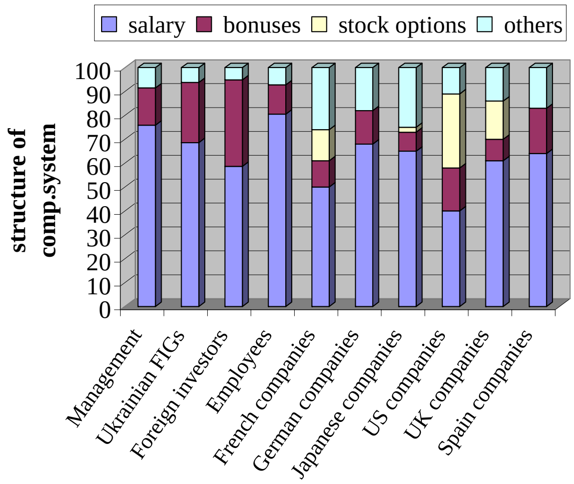


**Fig. 2.** Structure of Executive compensation at the companies, controlled by various groups of shareholders in Ukraine, and companies in other countries

Explanation of such remarkable difference in use of other beyond salary, bonuses and options instruments of compensation system in Ukraine and abroad is in the part of composition of other instruments.

In Ukraine, executives are granted a limited number of social compensations. For example, one of such compensations is obtaining from the companies paid recreation services in the Black Sea coast or paid trips abroad.

Other forms of compensation are not used in Ukraine. This concerns such instruments as restricted stock, long-term incentive plans (LTIPs) and retirement plans. For this time no company in Ukraine uses a long-term incentive plan. Meanwhile, there is no any evidence of use of this form of compensation. Abroad, in addition to bonuses plans, based on annual performance, many companies offer long-term incentive plans, typically based on rolling-average three- or five-year cumulative performance. For example, approximately 27 % of the S&P 500 CEOs received LTIP payouts in 1996. These payouts for 5.5 % of 1996 total compensation (and 20 % of compensation for those CEOs receiving payouts).

Abroad, in addition to participating in company-wide retirement programs, top executives routinely participate in supplemental executive retirement plans (SERPs). SERPs are non-qualified for the tax purposes and can take a variety of different forms, including defined benefits based on "credited" years of service (which can deviate substantially from "actual" years of service) or variable benefits based on inflation or company performance.

Ukrainian companies are still not experienced to use SERPs. Ownership structure and its concentration do not influence the situation. Companies, under control of foreign institutional shareholders still do not apply a long-term incentive plan, despite these companies have a very progressive short-term plan, based on incentive elements.

The main reason of an absence of long-term incentive plans at Ukrainian companies is a lack of well-defined long-term strategies. Thus, only 8 percent of researched companies in Ukraine have long-term strategic plans for the period of five years and longer, where certain corporate performance measures are clearly defined. Two of these four companies are owned by foreign institutional shareholders. From this perspective, an absence of long-term strategic plans does not allow companies to apply long-term incentives plans. Moreover, executives of major Ukrainian companies are reluctant to long-term incentives as elements of their compensation. Executives do their utmost to maximize their wealth within a short period of time. The reason is very common. This is an absence of belief of executives in the market opportunities of the companies. They are going to maximize their wealth as fast as possible before their companies go bankrupts or before coming other shareholders to the companies who would be unsatisfied with a quality of managerial services, provided by executives.

Summarizing all above, it should conclude that development of an incentive based compensation plan in Ukraine should start from development of long-term strategic plans, containing well-defined corporate performance measures. From this perspective, ownership structure plays very important role. Long-term strategic plans are demanded only by strategic shareholders, who know the value of strategic plans and who possess advanced knowledge how to develop strategy, monitor and reward executives who execute it. From this point of view, Ukrainian individual shareholders do not meet those requirements. Only institutional shareholders, mainly from abroad, meet those requirements.

## 4. Executive compensation system and size of the companies: looking for sensitivity

Abroad, it is not surprising that compensation increases with company size. Larger firms may employ better-qualified and better-paid managers (Rosen, 1982; Kostiuk, 1990). More surprising has been the consistency of the relation across firms and industries. Baker, Jensen and Murphy (1988) summarized Conference Board data on the relation between CEO cash compensation and firm sales from 1973-83 and document pay-sales elasticities in the 0.25 to 0.35 range, implying that a firm that is 10 % larger will pay its CEO about 3 % more. Rosen (1992) summarized academic research covering a variety of industries and a variety of time periods in both the US and the UK, concluding that the "relative uniformity across firms, industries, countries, and periods of time is notable and puzzling because the technology that sustain control and scale should vary across these disparate units of comparison".

In Ukraine sensitivity of level of compensation depends strongly on a size of companies. Under a word "size" we understand volume of annual sales of the companies. Sensitivity of level of compensation of executives of Ukrainian companies to volume of sales of companies, where they are employed is equal to 0.742. The above mentioned strong sensitivity does not differ sufficiently across companies under control of various groups of shareholders (see fig. below).

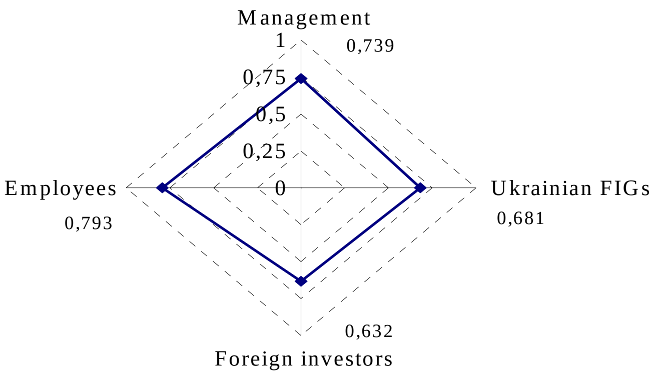


**Fig. 3.** Sensitivity of level of compensation of executives of Ukrainian companies to volume of sales of companies

Common sensitivity trend is explained by the following:

- an increase of volume of sales at the companies under control of Executives leads to increase of level of compensation because increase in volume of sales gives Executives an excellent chance to set larger salary, shadowed by large sales, despite very low correlation between sales and earnings;
- an increase of volume of sales by the companies under control of foreign investors leads to increase in level of executive compensation because increase in volume of sales is strongly correlated with earnings. Thus, increase in level of compensation happens because of growth in bonuses linked to earnings;
- an increase of volume of sales by the companies under control of Ukrainian financial-industrial groups leads to increase in level of compensation because increase in volume of sales, like in the case of companies under control of foreign investors is strongly correlated with earnings;
- an increase of volume of sales by the companies under control of employees leads to increase of level of compensation because increase in volume of sales, like in the case of companies under control of Executives gives Executives an excellent chance, using administrative levers of influence on employees to obtain larger compensation.

Thus, the third hypothesis, i.e. the size of executive compensation depends strongly on a size of companies, is vital.

## 5. Who sets executive pay in Ukrainian companies?

International experience of executive compensation system says that most large international companies have a compensation committee of two or more "outside" directors. Although all major decisions related to top-level pay are passed through this committee, the committee rarely conducts market studies of competitive pay levels or initiate or proposes new incentive plans, and only seldom retains its own compensation experts. Rather, initial recommendations for pay levels and new incentive plans typically emanate from the company's human resource department, often working in conjunction with outside accountants and compensation consultants. Here, executive compensation responsibility naturally varies with company size and complexity. Very large companies often have a fully staffed "Office of Executive Compensation", headed by a vice president who reports to either the Senior VP of Human Resources or to a VP of Compensation and Benefits. In smaller companies, executive compensation responsibility typically rests with the executive responsible for human resources.

Today, there are three models of executive compensation setting in Ukraine. The first model obliges Human Resource Department to develop executive compensation. As soon as it is developed, an executive compensation plan is brought to the Office of the Head of executive board to approve. If the head is not satisfied with the salary that is stated in the executive compensation plan, he is able to make the head of human resource department set the compensation, desirable by the head himself and the rest of executives. Besides this, it should note that executive compensation plan is not approved at the meeting of the executive board, where every member has his own point of view on the plan. The plan can be approved only by the head himself, in ordinary way, as compensation for middle-level managers. Under such circumstances, the head of executive board is like a dictator, who is able to make any member of the executive board vote for all decisions, as the head likes, under the threat of compensation cut.

Under this model, supervisory board is not involved in developing and approving compensation for executives. The reason, as a rule, is absence of skills at members of the supervisory board how to supervise an executive compensation practice. But the most important reason is strong dependence of members of supervisory board on executives.

The above model is popular in companies, owned or controlled (on the basis of proxy votes) by executives. Executives have strong levers to manipulate compensation and set it as they want.

The second model is a little similar to the model, discovered above. Human resource department develops an executive compensation plan. But, in contrast to the previous model, an executive compensation plan, as soon as it is developed, is brought to the supervisory board. The main task of the supervisory board is to approve or disapprove the plan. If it is approved, supervisory board pass the plan to the executive board and make them follow it. If it is not approved, the plan is brought to the human resource department back to enhance it.

Under the second model, supervisory board performs a function of "a rubber stamp". Therefore, performance of executive compensation plan depends rather on skills of human resource department than on skills of supervisory board. But, the human resource department is still under pressure, when developing the plan, of executives, who can try force them make the plan more convenient for them. Experiencing a pressure of executives and forcing by supervisory board, the human resource department faces a compromise. Being a socially responsible means to become an enemy for executives, who will make the further work of the human resource department terrible.

Therefore, the second model underlines that supervisory board supervises the executive compensation practice indirectly, through stamping the plan. At the same time, executives still save a chance to influence indirectly the process of development of compensation plan.

Under the third model, only supervisory board develops and approves the executive compensation plan. No human resource department takes participation in the process of development of the plan. From this perspective, the third model meets corporate governance principles. Executives are not able to influence the process of development and approving the plan. As a rule, companies, using the third model, establish a special committee within the supervisory board. This is a compensation committee. Compensation committee is responsible for developing an executive compensation plan. We could suppose that members of this committee develop the plan autonomously. We asked members of the compensation committees in Ukraine. All they replied that human resource department still participates in the process of development of the plan. As we found, compensation committee develops principles of executive compensation plan, approves compensation instruments. They do this in accordance with the corporate development plan where there are certain figures to tie it to the size of compensation. Moreover, members of compensation committee choose performance benchmarks, bonus standard, structure of bonus standard. All this information is brought to the human resource department. Human resource department officers should fill the draft of the plan with certain figures to complete. So, even executives try to press on human resource department to obtain more preferable compensation plan, they will not be able to change principles, instruments, and size of compensation.

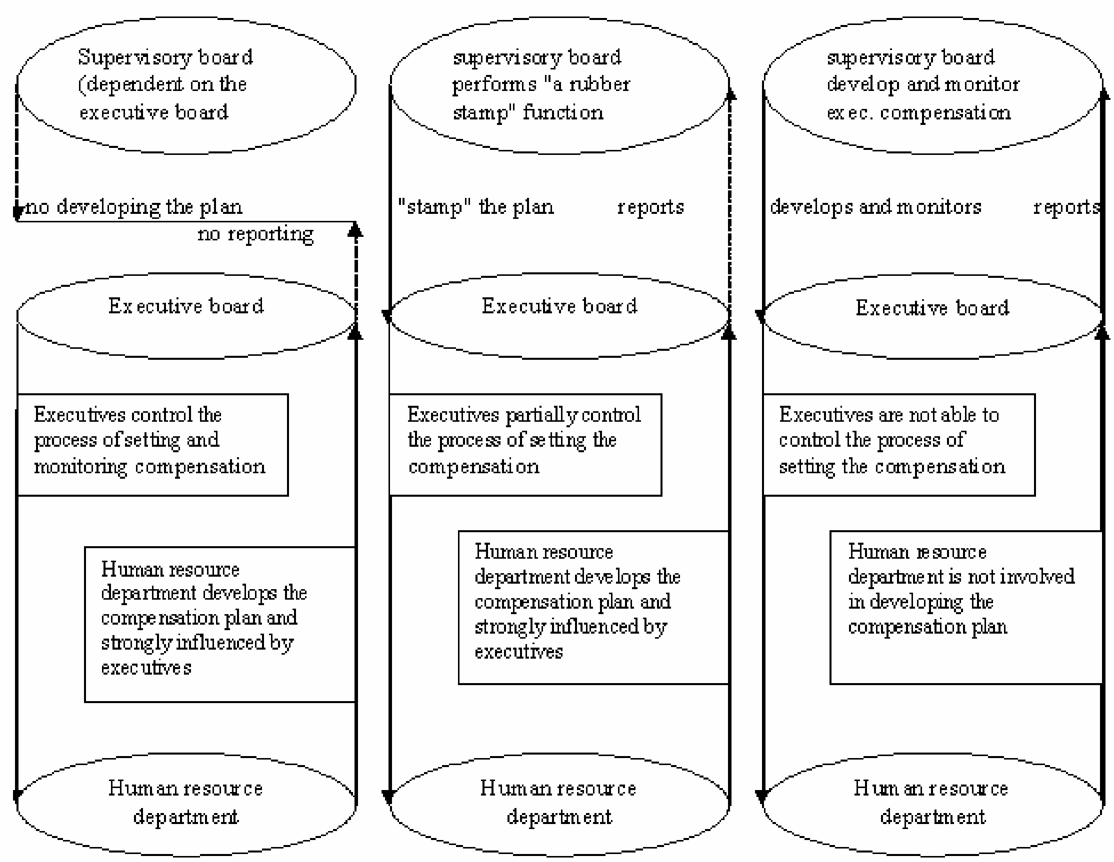


**Fig. 4.** Models of executive compensation setting in Ukraine

As soon as the draft of compensation plan is completed by human resource department officers, it is approved, if any, by compensation committee and brought to the supervisory board. Members of the supervisory board vote for final approving the plan. Regrettably, no Ukrainian company discloses information about executive compensation. Under such circumstances, monitoring of executive compensation practices is narrowed only to the supervisory board. No stakeholder has access to this information. Moreover, taking into account that minority shareholders have no their representatives on the supervisory board, minorities have no access to information about executive compensation too. From this perspective, executive compensation performs its incentive role only partially, meeting interests of large shareholders.

In Ukraine executive compensation setting actually rests on the company's human resource department. At the same time formal obligations to develop Executives incentive plans must be undertaken by Supervisory Board. Only a few Ukrainian companies have Compensation committees inside of Supervisory Boards. The most active in establishing Compensation committees in Supervisory Boards are those companies, which are under control of foreign investors. At the end of 2001 about 74 % of companies, controlled by foreign investors had Compensation committees.

Ukrainian companies, under control of other groups of shareholders are much less active in establishing Compensation committees. Thus, only 8 % of companies, controlled by employees established Compensation committees by the end of 2001. Companies, under control of Management are not active in establishing Compensation committees too. At the end of 2001 Compensation committees existed at 14 % of companies, controlled by Executives. Ukrainian financial-industries groups are little more active in establishing Compensation committees. Thus, at the end of 2001 about 23 % companies under control of Ukrainian financial-industrial groups had Compensation committees.

A lot of Ukrainian companies continue to use an approach to organization of setting a structure and levels of executive payouts, which was used under administrative-command system. The main corporate unit, responsible for development of Executive compensation plans is still the company's human resource department. Under such circumstances Executives (members of Management Board) are able to have an impact on a process of development of compensation plans. Executives use a lot of levers to press on members of human resource department including a threat of their firing.

Thus, the fourth hypothesis, i.e. the degree of independent decision making on executive compensation is very weak, is vital.

Until the transparency of Ukrainian companies improves substantially, Executive compensation system in Ukraine will not perform effectively a role of element of corporate governance system and efficiency of managerial services will not be linked tightly to the structure and level of Executive compensation.

## 6. Conclusion

Executive compensation is a term that needs further development in Ukraine. Fixed-based compensation is still the major form to reward executives at Ukrainian companies. From this perspective, Ukrainian practices for rewarding executives belongs to Continental model, developed in Germany. It can be explained by lack of: appropriate legislation, allowing stock based compensation; liquid stock market; lack of knowledge of directors (members of supervisory boards) on incentive based compensation; lack of control and executive monitoring functions by supervisory board. Moreover, a passive behavior of supervisory board in the field of development and supervising the executive compensation plans contributes to low efficiency of executive rewarding. Executive compensation monitoring is rather a myth than reality. The process is ruled by executives, and could be named "a dictate of executives".