

Nada Todorovic*

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MANAGERIAL REMUNERATION AND AGENCY PROBLEMS OF CORPORATE GOVERNANCE

Abstract

The author discusses the issue of remuneration for the company board members from the point of solving or mitigating the agency problems of corporate governance. Theoretical debates surrounding the eligibility of structures of managerial remuneration in companies have different starting positions. In a broader sense the issue of remuneration is seen as a way of transferring wealth within the company and can be accommodated within the traditional company management legislation. The ownership structure of the company, election of corporate bodies, as well as the delineation of their responsibilities cause agency problems of corporate governance. The model of dispersed ownership deals with the relationship between remuneration and the first agency problem (the relationship between shareholders and management), while the concentrated ownership model deals with remuneration and the second agency problem (relationship between majority and minority shareholders). This paper deals with the effect of the board structure on remuneration and gives an overall assessment of the link between remuneration and agency problems of corporate governance in Serbia.

Key words: *managerial remuneration, dispersed ownership, concentrated ownership, agency problems of corporate governance, incentive remuneration.*

1. INTRODUCTION

The issue of remuneration for the company board members (board of directors, executive board and supervisory board) cannot be considered separately from the basic institutes of corporate governance. As part of the reform of corporate governance, especially with the convergence of corporate governance systems on both sides of the Atlantic, managerial remuneration remains a controversial and an insufficiently transparent issue.¹ Theoretical debates surrounding the eligibility of managerial remuneration structures in

* LLD, Full-time Professor, University of Kragujevac, Faculty of Law (e-mail: ntodorovic@jura.kg.ac.rs).

¹ N. Todorović, J. Labudović Stanković, *Dugoročni podsticaji kao deo kompenzacionih paketa direktora*, *Pravni život*, 11/2013, 193.

companies have different starting positions. Issues related to managerial remuneration can be accommodated within the traditional company management legislation. The company is seen as a single entity, according to which managers have a fiduciary duty, which means that they do the work in the interest of the company, or in the interest of shareholders, and are obliged to avoid any activities in their own interest or any secret profits.²

In a broader sense the question of remuneration can be considered as a way of transferring wealth within the company. Managerial remuneration, itself, is not the source of agency problems. It can be the result of a wider market failure in the corporate control market, and therefore it is necessary to build a comprehensive strategy for managerial remuneration packages. This means breaking the total remuneration structure into the constituent elements, identifying causal relationships between the elements that make up a multi-layered system which represents the remuneration package for the members of the board of directors, the executive board and supervisory boards.³

Economically speaking managerial remunerations are not the source of agency problems in corporate governance. Homo economicus who brings rational decisions and seeks to maximize the utility through their economic activity is in the center of economic considerations. This is how both shareholders and managers behave. Shareholders tend to maximize the profit and increase the wealth and managers tend to manage the company in the interests of the owners (shareholders), but in their own interest as well. Their legitimate economic interest is valorized through the amount of remuneration. Problems in corporate practices arise while determining the modalities of remuneration payments.

The ownership structure of the companies, election of corporate bodies and delineation of their responsibilities causes various agency problems, all of which reflect the structure and the amounts of managerial remuneration. Our initial view is that remuneration itself is not the source of agency problems, it can be a means to mitigate these problems, or a tool that will allow their existing effect to come to the fore.

² G. Ferarini, N. Molney, C. Vespro, *Executive Remuneration in the EU: Comparative Law and Practice*, ECGI Working Series in Law, No. 09/2003, 5.

³ N. Todorović, J. Labudović Stanković, *Dugoročni podsticaji...*, 193.

2. THE RELATIONSHIP BETWEEN REMUNERATION AND AGENCY PROBLEMS WITHIN THE MODEL OF DISPERSED OWNERSHIP

Dispersed ownership structure involves separation of ownership capital from the function capital and transformation of the company into a broader ownership structure with professional management.

In those companies in which the ownership is dispersed into many shareholders (natural persons), supervision of the board members is much more difficult, which leads to the conflict of interest between shareholders and managers, and generates the first agency problem. In this ownership model, remuneration can be seen through the principles of optimal contracting, as a way to mitigate the first agency problem (traditional approach) and as an agency cost (modern approach), which is based on the managers' accumulated power to negotiate excessive remunerations.⁴

The principle of optimal remuneration contracting enables alignment of interests of shareholders and board members. Companies are doing business in a particular macro-economic environment and their business is influenced by economic and noneconomic factors, which is why favorable and less favorable business cycles take turns. Shareholders and managers should be oriented towards the future of the company in order to pursue a long-term business strategy.⁵ Optimal remuneration is the one that motivates managers to pursue a long-term business strategy, increases the wealth of shareholders and also attracts and encourages talented managers to stay in the company for a longer period of time. The incentive model, principal-agent, is, therefore the dominant model in the dispersed ownership. Managerial remuneration is seen as a remedy for agency costs arising from the conflict of interest between directors and shareholders in the model of dispersed ownership.⁶

In order to balance all these objectives in the optimal remuneration contracting, contracts on payment should be concluded based on performance and incentive remunerations should be paid. This would lead to a more coordinated approach to the division of profits in the company. A harmonized approach to the division of the company's profits between shareholders and directors is achieved through payments of incentive (stimulative) remunerations which represent a variable component of the total remuneration package for the company board members. Incentive

⁴ V. Radović, *Naknade članovima uprave akcionarskog društva*, Beograd, 2011, 31-36.

⁵ N. Todorović, J. Labudović Stanković, *Dugoročni podsticaji...*, 194.

⁶ G. Ferarini, N. Moloney, C. Vespro, *op. cit.*, 5.

remunerations may be related to the increase of shareholder's wealth directly (remuneration in shares or share options), or indirectly through bonuses according to performance.

From an economic standpoint the payment of these remunerations is an additional cost for the company and it reduces the wealth of shareholders (owners), but as long as this cost leads to increased company profits, strengthening its competitive position in the market and price growth of its shares on the stock exchange, it is justified because the marginal benefit for shareholders is greater than the marginal cost. In addition to increased marginal costs, lowering total costs of the company business can also be the economic result of the managerial incentive remunerations payment. All this raises the question of remuneration structures, the relationship between fixed and the variable components and especially the issue of long-term incentives as an integral part of the remuneration package for the board members.

Options are a type of long-term incentives and an important element of the total managerial remuneration structure, especially in the model of dispersed ownership. Options attract investors due to asymmetric payments.⁷ The difference between the unlimited profits of the call option buyers, when the share prices in the market rise, and the amount of optional premium, which is the maximum loss when the share prices fall, is the source of asymmetric payment. This is the basic economic logic, which should be followed by the call option buyers, while buyers of put options follow the same logic, but in reverse. The buyer of the put option has interest in the share price falling in order to make asymmetric payment through exercising the put option. Asymmetric payments indicate that buyers and sellers have contrary expectations regarding the movement of prices of basic financial assets. The buyer of a call option expects the share prices to rise, and the put option buyer expects them to fall. Sellers of call options expect the price to remain unchanged or to fall, while sellers of put options expect the prices to remain unchanged or to rise.⁸

Creating options favors the interests and expectations of both shareholders and managers and they are an integral part of the long-term incentive program. Shareholders' expectations from the managers' use of options are the following: increase of company profits through higher share prices on the stock market, reduction of agency costs, attracting and retaining talented managers for whom there is an increasing demand in the market,

⁷ L.S. Ritter, W.L. Silber, G. F. Udell, *Principles of money, banking and Financial markets*, 2004, 171.

⁸ Lj. Nikolić, *Berzansko pravo i poslovanje*, Niš, 2008, 125.

orientation of managers towards long-term business strategy of the company. In practice such corporate expectations of shareholders may be discouraged by the managers.

Managers who receive options as a form of compensation must be familiar with optional strategies that are available to them. Managers have great expectations from the purchasing call options, and this is why they are so attractive and popular. The manager of the company who owns a three-month call option on the 50 shares of the XY company at a price of \$ 100 per share has several options depending on the movement of prices on the market. He may decide not to exercise the option nor to buy 50 shares of the XY company at a price of \$ 100 per share during the holding period of the option. This would happen if the company share prices fell. Then the managers would not exercise the call option and they would not buy 50 shares of the XY company, because of the fall of the share prices, from \$ 100 to \$ 95, and it would not be in their best interest to exercise the call option. The option will be exercised if the manager can make a profit out of the option. In case the share prices of the XY company rise on the market, the manager owning a three-month call option will exercise it at the price of \$ 100 per share and will become the owner of 50 shares which he will be able to sell at the price of \$ 105 and make the profit of \$ 5 per share. Options are one of the long-term incentives, or bonuses based on increasing value (appreciation) and they bring profits to the manager when the market price exceeds the exercise price (the strike price of the option). Managers achieve their economic goals through options, because they make sums of money equal to the difference between the strike price and the market price of the shares on the date of execution.⁹ This raises the question of option pricing models according to international accounting standards and the issue of the tax treatment of the profit made by managers. If this income was treated as capital gain and was subject to taxation, then managers would not be motivated to use this type of long-term incentives. This difference is taxed as ordinary income so that the managers would be motivated and retained in the company.¹⁰

⁹ M. D. Graham, T.A. Roth, D. Dugan, *Effective Executive Compensation*, AMACOM, 2008, 314.

¹⁰ According to International Accounting Standards, the most famous options pricing model is the Black-Scholes options pricing model in which options are shown in the form of expenses for compensation in the income statement and include the award period or period of execution.

Managers can use the options as long-term incentives in a way that threatens the interests of the owners of capital and in such case the options are subject to abuse. These long-term incentives are created and assigned to managers so that they would be motivated and retained in the company and in order to align their interests with the interests of shareholders, which would ensure long-term business success.

Options have been expanding since the nineties because of the tax and accounting benefits. Companies did not report them as expenditure and they did not affect the income statement of the company. A large amount of assigned options diminished the value of existing shares, and potentially threatened the formed corporate culture and led to long-term instability in companies. The managers were motivated only in the short term. They sought to ensure the growth of share prices only on a quarterly basis and wanted to achieve greater profits from shares through exercising the options. The capital of the company watered down through the issuance of options and interests of shareholders were threatened.

Companies have significantly reduced the issuance of options lately, because of the stricter international accounting standards, as well as the investors' caution and suspicion towards those companies that use options as long-term incentives. The options as long-term incentives are more prevalent in the US than in Europe. Boards of directors in the US have often reduced the costs of options presented to managers which caused emergence of some corporate scandals. After certain changes in the accounting regulations, an obligation was established for the board of directors to report the full cost of the options, as well as to inform shareholders about the full costs of options and plans related to compensation packages. Managerial remunerations in Europe are mainly based on a fixed amount, and long-term incentives (options)¹¹ are less present in compensation packages. Requirements on disclosure of managerial pay have been tightened recently. This has led to the increase of managerial remuneration and reviewing the structure of compensation packages.

European managerial labour markets were not too attractive for American managers because managers in Europe had lower salaries, partly due to the more coherent accounting and tax systems in terms of economic costs of options. Requests for disclosure of information about managerial pay are becoming louder, and European managers are trying to make their compensation packages more similar to the US packages. Thus, in some

¹¹ A. Melis, *Corporate Governance in Italy*, in: *European Corporate Governance* (ed. T. Clarke and J.F. Chanlat), 2009, 89.

European countries there was an increase of managerial pay from 40% to 70%. Switzerland is a good example, since the chief executive's salary in 2001 was \$405,000 while in 2003 it rose to \$1.1 million. In Germany, \$455,000 rose to \$ 955,000. However, the average value of the compensation package in the United States is almost twice the size of the largest managerial pay in Europe. The average is about \$2.25 million.¹²

The essence of all abuse related to the allocation of options boils down to the fact that the allocation and exercising of options ensures that managers receive a high income based on unethical behavior and breaches of accounting and tax regulations. This income stems from cash transactions of the company and the shareholders pay the price for it. The behavior of the members of the board of directors, executive directors and supervisory boards may be legal but contrary to the principles of financial ethics. So the directors use very flexible ways to increase their salaries ("backdating and finagling") that are not in conflict with the law.¹³

There is greater alignment of shareholders' interests with the interests of managers in case of using bonuses based on increase in value instead of options. These rights to bonuses are equal to the company's share appreciation rights over a certain period of time. This type of long-term incentives is similar to options, and shareholders are less suspicious of these bonuses than of options. In addition to the great similarities, there is a line of demarcation between bonuses and options and it comes down to the fact that managers who get bonuses do not become shareholders, they make profit based only on the increase in the share prices and the strike price is not paid.¹⁴ The difference between the market share price on the bonus award day and the share price is paid in cash. Shareholders agree that managers should receive these bonuses based on the increase of the value of shares (appreciation) because they believe it would give fewer opportunities for abuse compared to the allocation of options. Managers are motivated to advocate the increase of share prices of companies, because it guarantees the benefits for them. Both bonuses based on increase in value (appreciation) and the options are connected to the share prices and the increase in those prices, the only difference being in the fact that bonuses are based solely on appreciation.

¹² See K. J. Murphy, *On Executive Compensation: Is Europe Catching Up with the US, and Should It Do So?* in: *Corporate Governance in the US and Europe, Where Are We Now* (ed. G. Owen, T. Kirchmaier and J. Grant), Palgrave Macmillan, New York, 2006, 61-64.

¹³ N. Todorović, J. Labudović Stanković, *Dugoročni podsticaji...*, 198.

¹⁴ M. D. Graham, T.A. Roth, D. Dugan, *op. cit.*, 320.

3. THE RELATIONSHIP BETWEEN REMUNERATION PROBLEMS WITHIN THE CONCENTRATED OWNERSHIP MODEL

Concentrated ownership is based on pyramidal ownership structure. Pyramidal groups are groups of companies among which control is established with minimal costs. Company owners are powerful families, family associations or banks. Concentrated ownership has certain advantages in the economic sense. Practice shows that capital invested in companies owned by families is more efficiently used and increased than the capital owned by a large number of shareholders.¹⁵ In the concentrated ownership models the majority owners also manage the company, so the interests of shareholders and the management are more in alignment than in the dispersed ownership model. The second agency problem comes into play here, and this is the clash between the controlling-majority shareholders and the minority shareholders. Managing the company within this concentrated ownership model has certain shortcomings, such as self-dealing or tunnelling.

Self-dealing is the transfer of values from the companies where the majority shareholder owns a small fraction of cash-flow rights (lower position in the pyramidal structure), to those companies in which the majority shareholder owns a larger fraction of cash-flow rights.¹⁶ The way to realize this is to perform transaction between the partners.

In the family-controlled corporations members of the management board are appointed by the majority shareholder and they provide them with private benefits of control. This is manifested through block premiums and voting premiums. A block premium is the difference between the share price paid in the block transaction and the share price on the market. A voting premium is the difference between the market share price with the voting right and the preferential price without the voting right. Both of these premiums are large in family companies and the difference in the premium prices is the private benefit of control for the majority shareholder. One of the best examples is the collapse of the Parmalat company in Italy. Parmalat was a typical family-controlled corporation with the Tanzi family as the major shareholder. The company used corporate resources through self-dealing. The company gave false reports on their losses, costs and debts while the

¹⁵ N. Todorović, *Porodični kapitalizam i korporativno upravljanje*, *Pravni život*, 11/2011, 160.

¹⁶ L. Enriques, P. Volpin, *Corporate Governance Reforms in Continental Europe*, *European Corporate Governance* (ed. T. Clarke and J.F. Chanlat), Routledge, London and New York, 2009, 256.

money was funnelled into the Tanzi family. From March 1990 to December 2003 the Parmalat group used up around 18.2 billion of funds, and 3 billion of these funds were spent by the family for the unknown purposes.¹⁷ These problems gained importance with the beginning of the globalization process, when powerful multinational companies started spreading their business all over the world. They tend to conquer new markets, new products, new technologies and reduce the costs through various forms of associations and concentration of capital.

Agency problems between majority and minority shareholders are caused by ownership structure of the companies. Remuneration structure and the regulations related to determination of that structure, especially remuneration transparency, more or less accelerate this problem.

In the concentrated ownership model remuneration structure should be directed towards creating a long-term incentive program. This means that managerial remuneration should be connected to the managerial performance. Results of the company business allow for the possibility of high managerial remunerations with the total revenue, company profits and the rising of share prices being the economic indicators of successful business. Rising of company share prices on the stock market is favoured by both majority and minority shareholders. This is why connecting remunerations to shares based on performances will be in their mutual interest as well. The use of bonuses at full value of restricted shares, shares based on performance and cash bonuses as long-term incentives for harmonizing the interests of shareholders and directors has limited effect and causes various consequences in corporate practice, especially in the EU.

The European model of corporate governance, which is usually bicameral, is based mainly on fixed managerial remuneration. The reason for this lies in one part of the theory which states that concentrated ownership harmonizes the interests of majority shareholders and the management and therefore there is no need for introducing the variable component of remuneration, i.e. long-term incentives. The variable component of remuneration based on long-term incentives can also have some disadvantages. It can cause some excessive remunerations which threaten the interests of minority shareholders and the interests of the company itself. Managers whose remunerations are linked to higher share prices can be manipulative towards the employees and the minority shareholders. They can lower salaries of the employees and manipulate disclosure of information, all for the purpose of short-term increase in shares.

¹⁷ *Ibid*, 257.

Remunerations based on performance can cause wide ranges in the amounts of remunerations that are the result of movements in the stock market. The movement of share prices is unpredictable, capricious and the only thing that is certain in relation to the movement of share prices is that they will fluctuate, and that their movements are affected by economic and noneconomic factors. When the stock market grows rapidly, it carries the danger of giving inappropriately high managerial remunerations to those managers who manage the company during the period of market growth and much lower remunerations for those managers who manage companies in the period of the rapid market decline. Thus, the stock exchange breaks in the stock market amplify the disparities in determining the level of remunerations when the remuneration structure is dominated by long-term incentives.

Therefore EU legislation, both imperative and dispositive, and the Committee on Remunerations are directed towards stricter requirements for disclosure of the amounts of remunerations and also towards limiting the amounts of variable remunerations. This is why variable remunerations awarded to managers of the majority of EU banks have been limited to 100% of the fixed remuneration, since January 1 2014. The Dutch government was particularly restrictive concerning this matter because it suggested limiting the variable remuneration to 20% of the fixed remuneration,¹⁸ starting from January 1 2015. Corporate practice in the EU is going towards stricter requirements for disclosure of remunerations, shareholders' approval of variable remunerations and limitations of variable remunerations. Imperative legal norms for protecting minority shareholders and the renaissance of the shareholders assembly as the highest authority in the company should be added to these basic trends in the corporate control market. The final decision on the amount of remuneration must be made by the shareholder assembly, and the elements of the special contractual arrangement with managers must be transparent for shareholders.¹⁹ Shareholders may seek judicial protection through filing derivative suits²⁰ for the damage suffered due to payment of excessive remunerations.

¹⁸ Executive Remuneration – Europe, Corporate Governance Developments (June 2013), Tower Watson, <https://www.towerswatson.com/en/Insights/IC-Types/Technical-Regulatory/2013/Executive-Remuneration-European-Corporate-Governance-Developments>, 9.9.2016.

¹⁹ M. Vasiljević, *Korporationo upravljanje: pravni aspekti*, Beograd, 2007, 190.

²⁰ Art. 79 of the Law on Companies (Zakon o privrednim društvima), *Official Gazette of the Republic of Serbia (Službeni glasnik RS)*, No. 36/2011, 99/2011, 83/2014 and 5/2015.

Economically speaking, the derivative lawsuit is a risk for minority shareholders, because in case of losing the dispute they bear all the costs, which usually keeps them from filing the suit in the first place.

4. THE EFFECT OF THE BOARD STRUCTURE ON REMUNERATION

The reform of corporate governance is moving towards convergence of existing models of corporate governance (American unicameral and European bicameral) and strengthening of internal and external mechanisms of corporate governance. Concentrated ownership in the bicameral model of corporate governance (Europe) decreased the strength of internal mechanisms of corporate governance, i.e. the board of directors, undermined the protection of minority shareholders and caused inefficiency of external corporate governance mechanisms (such as a hostile takeover, the activity of investors).²¹ On the other hand, unicameral model of corporate governance (US, UK) has its drawbacks, such as strong boards of directors, weak shareholders, short-term business strategy focused on the enrichment of shareholders and managers.

Boards of directors are different in their structure in unicameral and bicameral models of corporate governance. American boards of directors are strong, independent, more operational, while the European boards are connected to the majority shareholder and are more numerous due to the participation of their employees. Economic parameters that affect the remuneration of board members are the company revenue, its size, number of employees, shareholders returns on invested capital. Empirical studies in the US show that the structure of the board has an impact on remuneration of chief executive officers. The analysis of the committee structure was performed on S&P 500 companies, searching for the connection between the title (function) of the board members and their salaries. Special attention was given to finding out whether combining (merging) of various corporate roles has any effect on the amount and structure of remuneration.

The chief executive officer (CEO) is responsible for the operational management of affairs and chairman of the board supervises the management and the operational management of the company. Combining

²¹ N. Todorović, J. Labudović Stanković, *Korporativno upravljanje – potreba za efikasnijim i kvalitetnijim upravljanjem i društveno odgovornim ponašanjem*, u: Usklađivanje pravnog sistema Srbije sa standardima Evropske unije (ur. S. Đorđević), Pravni fakultet Univerziteta u Kragujevcu, Kragujevac, 2014, 642.

these roles leads to the situation in which the chief executive officer is also chairman of the board and this role is crucial in practice when determining remuneration. Some recent trends in the United States show that the number of companies that combine these two corporate roles has slightly declined because it causes difficulty in determining the level of remuneration. Thus, in 2014 about 54% S&P companies combined the role of chairman of the board and the chief executive officer, while in 2015 about 51% S&P companies had such a solution in the structure of the board of directors.²²

Research on committee structure for companies S&P 500 for the last three fiscal years (FY2012-FY2014 and FY2013-FY2015), showed that the roles of chairman of the board of directors can be different. The chairman may appear in a combined role (one person is also the CEO and the chairman) or may be an insider, i.e. someone who is employed by the company or holds more than 50% of the voting power of the company. The chairman could also be the 'connected' outsider, former chief executive officer, non-executive director or an independent outsider, when the chairman has no material connection to the company.

Results of the research showed that the chief executive officer's average annual remuneration varied depending on their corporate roles. Chief executive officers in boards of directors with an insider made the highest remuneration of \$15.6 million a year during a three-year period, followed by chief executive officers with a combined role in the company, \$13.8 million. 'Connected' outside directors made \$ 11.3 million and an independent outside directors made \$ 11 million on average.²³ Studies have shown that the company's revenue and the structure of the management of the board are correlated with the levels of chief executive officers' salaries.

5. AGENCY PROBLEMS AND MANAGERIAL REMUNERATION IN SERBIA

Development of shareholding in Serbia was slow and this is why corporate control market is underdeveloped. A large number of joint stock companies that exist today have been created through the process of privatization, so concentrated ownership is the dominant structure here. The prevailing organizational form of the companies in Serbia are companies with limited liabilities and solely owned joint stock companies, while public

²² C. Bowie, *Board Leadership structure: Impact on CEO Pay*, <http://corpgov.law.harvard.edu/2016/03/board-leadership-structure-impact-on-ceo-pay/>, visited: 9.9.2016.

²³ *Ibid.*

joint stock companies are rare because the existing joint stock companies cannot meet the strict regulations and procedures required for public joint stock companies (scope of capital, scope of sales, number of employees, public issues).²⁴ After the process of privatization the majority shareholder who controls the management became dominant in joint stock companies in Serbia, which is why concentrated ownership prevails here. This causes agency problems between majority and minority shareholders. Fixed remunerations²⁵ became dominant in remuneration structures, but the arrival of multinational companies in the Serbian market brings managerial remuneration based on corporate performance (revenue, company profit).

Managerial remunerations are now viewed from the aspect of solving agency problems of managing the companies and they serve to align the interests of managers and shareholders.²⁶ For the economic theory the issue of managerial remuneration is a business cost, a type of necessary initial investment which will ultimately result in appropriation of higher profits. Necessary preconditions to resolve the issue of remuneration in the interests of managers and shareholders are adequate legislation and transparency.

At EU level, the issue of managerial remuneration has found its place in the Report on the Reform of High Level Group of Company Law Experts, the Recommendations of the European Union Commission on remuneration of directors of listed companies and in the Green Paper published by the European Commission in 2011 on the corporate governance framework,²⁷ and is further developed in national legislation by the Law on Companies and Corporate Governance Codes.

The Republic of Serbia adopted the Law on Companies in 2011 and the Corporate Governance Code in 2012. The key provision in the Law on Companies concerning remuneration is the one that puts the issue of remuneration under the jurisdiction of the Assembly.²⁸ The Law on Companies provides that remuneration may be fixed and variable in its structure. The director is entitled to remuneration for their work, but may also be entitled to stimulation through allocation of shares. The level of

²⁴ B. Begović, M. Bisić, B. Živković, B. Mijatović, A. Jolović, K. Đulić, *Korporativno upravljanje pet godina kasnije*, Beograd, 2008, 54 and further.

²⁵ *Ibid.*, 45.

²⁶ M. Vasiljević, *op. cit.*, 199.

²⁷ European Commission, *Green paper: The EU corporate governance framework*, COM (2011) 164 final, Brussels, 2011.

²⁸ Art. 393 of the Law on Companies.

remuneration is determined by the Statute, the decision of the Assembly or the supervisory board, if the company management is bicameral.

The Law on Companies provides for the establishment of a commission for remuneration within the board of directors of a public joint stock company which gives the proposal on the amount and structure of remuneration for directors and prepares a draft decision on remuneration policy for executive directors.²⁹ The formation of this commission is in line with recommendations and regulations of the EU because it does not have the function of the Committee on Remuneration.

Serbia adopted the Corporate Governance Code in 2012 in which the existing legislation was expanded at the level of principles and recommendations. One part of the Code is dedicated to managerial remuneration. The aim of determining remuneration for the members of the board of directors, executive board and the supervisory board is to encourage them to stay in the company and to stimulate them to do their work in the interest of the company as well. The Code states the difference between remuneration structure for executive directors, which consists of a fixed and a variable component, and remuneration for non-executive directors, which only has a fixed component.³⁰ Limitation of variable components, provided for in the Code, should enable the interconnection between the interests of executive directors and interest of the company.

Remuneration policy in joint stock companies is particularly developed through additional principles and recommendations for joint stock companies and within those, long-term incentives have been particularly considered. Joint stock company assembly must approve all remuneration plans related to long-term incentives, based on shares, options and other rights to acquire shares. The assembly gives prior consent to the assignment of options, determines conditions for acquiring options and conditions for exercising the options. This way, the joint stock company assembly, as the owner of the capital body and as the highest authority, prevents possible abuse of options (such as back-dating and finagling).

Corporate Governance Code particularly emphasizes the need for transparency and it has issued a disclosure obligation according to which the company needs to disclose all information on remuneration for the members of the board of directors, executive boards and supervisory boards, so that the investors can request them and conduct a proper evaluation of their

²⁹ Art. 409 of the Law on Companies.

³⁰ Principle 9 of Codex of Corporate Governance (Kodeks korporativnog upravljanja), *Official Gazette of the Republic of Serbia (Službeni glasnik RS)*, No. 99/2012.

adequacy.³¹ In practice, although there are appropriate legal and autonomous regulations, information on remuneration of directors are not sufficiently transparent. Especially small shareholders who have not been educated to use all of their rights at the assembly meeting and are not informed on all matters concerning the company's business, including issues of remunerations.

The issue of remuneration in the public sector is of particular importance. The owner of public corporations is the state and it has to motivate the management to efficiently manage the business performance of public corporations. One of the ways to do this is to pay remunerations to the members of supervisory boards and directors who need to monitor developments of the market in the private sector managerial markets. This remuneration issue is actually the one that could cause agency problems between the state and the supervisory board on one side and directors and executive directors on the other. The new Public Corporation Law has completely linked executive directors to the directors of public corporations, so that the act on remuneration payment for executive directors is proposed by the director of the public corporation. It is understandable that the aim of this legal solution is professionalisation of management, but it's realistic to expect that in their professional behavior executive directors will give the advantage to the interests of directors they depend on, over the interests of the owner (state).³² The role of the supervisory board is to articulate and align all these interests and to prevent the conflict. Fixed remuneration is the dominant one in the remuneration structure of public corporations, which is why introduction of incentive remunerations would motivate directors of public corporations to turn towards creating values in the public sector on behalf of the owner (state) and in the interest of citizens. Caution is necessary when introducing incentive remunerations for directors of public corporations, because engaged resources (costs) of the state, and managerial pay is considered as an expense, must not exceed the benefits from public corporations' business to the whole society.

6. CONCLUSION

The starting point of the author is that remuneration itself is not the source of agency problems. It only reflects economic behaviour of the board

³¹ Codex of Corporate Governance, principle 36.

³² N. Todorović, J. Labudović Stanković, *Novi korporativni okvir za javna preduzeća*, Pravo i privreda, 4-6/2016, 95.

members. Agency problems of corporate governance are caused by the ownership structure in companies, election of corporate bodies as well as delineation of their responsibilities. Remuneration can be the means to mitigate these problems or it can also be the means to make their existing effects come to the fore. In the dispersed ownership model, remuneration should reduce the effect of the first agency problem (shareholders and board members), through the optimal contracting principles (traditional approach).

In the concentrated ownership model remuneration should reduce the effect of the second agency problem (majority and minority shareholders). This can be achieved through a balanced relationship between fixed and variable remuneration and limitation of variable components of remuneration, which has been a trend in the EU in recent years. Variable components of remuneration are, to a certain extent, desirable and stimulating for directors, but if they lead to accumulation of powers of the board members in the dispersed ownership model, and to accumulation of powers of majority shareholders in the concentrated ownership model, they generate agency problems.

Results of empirical studies show that the structure of the board is in correlation with the levels of salaries of executive directors. Concentrated ownership is dominant in Serbia, and fixed remuneration is dominant in the remuneration structure and its aim is to align the interests of shareholders and managers, which is difficult to achieve in practice.

Remuneration structure should be balanced so that they represent superior corporate performance. In the future, strategy in the formation of remuneration must be focused on the portfolio approach, because this is the way to unify the interests of shareholders and directors.

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