

The Role of System-Forming Committees at Boards of Directors in State-Owned Companies (PJSC) in the Russian Federation

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Abstract. To ensure the effective work of the board of directors in accordance with the best management practices in the field of corporate governance, it is required to organize and improve the work of committees. The subject of this paper is important and interesting also in that in the majority of mid-sized state companies committees under the board of directors have more of a decorative function to them and fail to provide the advantage that is expected. Due to this, what suffers first is corporate control and what potentially follows is corporate corruption. Insufficient concern for control (audit committee) and remuneration policy (HR committee) might result in these adverse consequences. The findings and conclusions presented in this paper came from the author's work as a board director in Russian companies with state participation. Our suggestions on how to improve the incentive side of the work of top management and board of directors have been based on world's best practices, on the corporate governance code en force, and can be of value to public authorities in revising and refining current regulatory documents.

1. Introduction

For the effective performance of members of board of director in line with the best management practices in the field of corporate management, it is necessary to organize and improve the work of board committees.

As a rule, in Russian companies the most wide-spread are the following committees: "Audit Committee", "Strategy Committee", "Human Resources and Compensation Committee". [1, 243].

The key goals and objectives in the field of committee management:

- committees implement preparation of decisions for the board of directors and consideration of the key strategic issues to be considered by the board members;
- at the same time, each public selects for itself several committees in dependence on its challenges ahead and availability of needed resources for the workflow management;
- in a number of countries, availability of the board committees is mandatory in compliance with national management codes and other normative documents, in order to ensure the fulfilment of key managerial functions by the board of directors.

The process of establishing and setting in motion each individual committee has both strengths and weaknesses.

To the advantages belong:

- focusing the attention on the concrete ‘specialized’ aspects of a committee’s work;
- developing, in a committee, of special skills and competences;
- supporting board members in decision making; more time for and closer attention to consideration of strategic issues;
- a chance to reconcile differences and settle disputes before key board meetings;
- providing an expert knowledge base for company executives.

Among the downsides are the following factors:

- due to a certain amount of red tape, this can take up more time of board directors, management and executives;
- there is always a danger of estranging committees’ work from that of the board of directors, if their respective schedules were not reconciled beforehand, for a length of a year at the least; also, control over the work of committees by the board chairman might be gravely hindered;
- a drastic increase in the flow of reports, accounts and memoranda to them.

2. Methodological framework

In our view, for today’s Russia in its development of corporate governance essential are such committees as the Audit and the HR and Remuneration, the latter also deserving special attention .

For the purposes of a company’s better performance, higher transparency in company control processes for the management, increased responsibility of managers to the shareholders for attaining long-term, short-term and operating goals, a system of business control has to be established on the basis of the Controlling and Internal Audit Committee.

Historically, first ever audit committees were set up in 1939 in the USA; but they became common and useful not before 1977. The spur for audit committees’ introduction was an epidemic of corporate scandals in early 2000s entailing the collapse of such industrial giants as Parmalat, Enron, WorldCom, along with the adopting of the Sarbanes-Oxley Act in the USA that strengthened managerial responsibility in companies and raised the role of audit committees attached to Boards of Directors].

One of the primary reasons for setting up such a committee was the desire to be sure that a company’s management fulfill their obligations towards shareholders in their entirety when preparing financial and accounting documents. Corporate management legislation fails to keep up with that covering business operations in an open economy. It was due to this very reason that certain global developments in the corporate management legislation and practices – and first and foremost in what pertains to audit committees and their function – was a response to emerging challenges. Normally, such innovations were worked out and introduced in reaction to contractors’, lenders’ and investors’ claims coming in, who had got tired of receiving corrupted information on companies’ performance, among other things financial and accounting statements, that was usually designed to hide cases of corporate abuse and fraud on the part of management, which in its turn led to a series of bankruptcies at various markets.

What we should see as a result of the work of a properly organized audit committee is better confidence among key stakeholders and contractors that a company relies on all the due and prescribed procedures and processes related to how internal auditing submits corporate reporting statements.

In this paper, however, we will focus on the human resources and compensation committee whose main goal – according to best practices in corporate governance – is to ensure efficient strategic HR management and control over managerial activities related to human capital.

In the centre of this committee's attention normally are: the board of directors (and its individual members), the corporate secretary, and a range of other managerial bodies being a part of the system of a company's corporate management. Also a focus of attention is directed on the individual executive body (CEO), top managers, members of the executive board and other employees holding key positions in the company.

When setting up the human resources and compensation committee, it is recommended to include therein independent directors solely. In the practice adopted in Russian State companies, in particular relative to the medium-sized business sector, it is virtually impossible, due to this fact it is recommended to have this committee governed by an independent director and consist of non-executive directors (who are not company executives).

The main tasks of the human resources and compensation committee can be grouped into two main blocs:

1. In relation to the board of directors and corporate management bodies:

- generating proposals pertaining to the composition of the board of directors, the structure of its committees and other bodies of the corporate management system;
- searching for and attracting candidates to members of the board of directors, other bodies of corporate management; creating succession pool;
- establishment of a system of control over observation of principles of board's members independence;
- carrying out activities to ensure the start-up of the enterprise, bringing of board of directors and new executives in the corporate management ;
- most important here is that the board's performance is to be evaluated regularly, which has not yet become part of the practice adopted in Russian State companies;
- creating appropriate atmosphere and holding events contributing to a better coordination and communication among board of directors and the members of the committee; and ensuring cooperation with the top management of the corporation;
- preparing and implementing staff development programs for the corporate management;
- developing recommendations on awards/incentives and compensations for the members of the board, its committees and other corporate managing bodies;
- disclosure of information on remunerations and compensations – a critically important activity aspect, among other things due to a recent series of corporate corruption scandals in companies with state participation ("Russian Railways" PJSC , "Rostelecom" PJSC) due to unreasonably high compensation payments to board of directors and top managers (employee stock options, golden farewells, etc.)

2. In relation to the corporation directly:

- establishment, development and maintenance of the system of corporate management;
- participation in the working out of the company's strategic development plan, particularly in the segment of HR management;
- carrying out evaluation and proposing recommendations based thereon concerning incentives for key executive officers of the company;
- preparation of guidelines and recommendations on succession policies (talent pool), and control over compliance therewith;
- supervision and control over implementation of the strategy, policies and procedures in the above areas, as well as in relation to other aspects of the company's activities in accordance with the committee's mandate.

It is important to pay a special attention to the policy on remunerations for board of directors' members in state-owned corporations. Basically, in such companies, as a rule, there is only a fixed

(constant) remuneration whose possible rates are given in the table below, in accordance with the Ministry of Economic Development recommendations [2].

Table 1. Remunerations for board of directors' members in state-owned corporations.

ANNUAL REVENUES OF JSC	Recommended basic compensation rate for board members
Over 200 billion RUR	1 000 000 RUR (basic)
Over 30 billion RUR	900 000 RUR (coef. = 0.9)
Over 10 billion RUR	800 000 RUR (coef. = 0.8)
Over 1 billion RUR	700 000 RUR (coef. = 0.7)
Over 600 million RUR	600 000 RUR (coef. = 0.6)
Over 300 million RUR	Not more than 300 000 RUR (coef. = 0.3)
Over 100 million RUR	Not more than 150 000 RUR (coef. = 0.15)
Not exceeding 100 million RUR	Not more than 100 000 RUR (coef. = 0.1)

Currently, the source of finance for remunerations to be paid to state-owned corporation's board members is the net profit of the company. This position was explicitly reflected in letters from the Finance Ministry of Russia (No. 03-04-07-02/2, of January 26th, 2007) and from the Ministry of Economic Development of Russia (No. D08-3156, dated September 28th, 2009) [2].

3. Discussions

This approach has the disadvantage of providing less incentive to members of board of directors of state companies for achieving the approved and adopted KPIs; it also does not promote attraction of forward-looking executive officers to work in boards of directors in companies partially owned by the state, particularly in medium and small sized companies where 'staff scarcity' is felt more than elsewhere. There is no stimulus for combating corporate corruption which has, unfortunately, spread far and wide in state companies, especially, of medium and small segments.

It appears to be quite obvious that such approach requires a 'hot fix' and without much delay; even in those companies that do not show profit at the moment, CEOs are to be paid well, it is particularly important where rehabilitation and restructuring are needed in order to save a company from bankruptcy or a forcible takeover.

In accordance with the Federal Property Management Agency Guidelines (published on the Agency's web-site) on using Key Performance Indicators (KPI) in state corporations, companies, unitary enterprises, as well as business entities with more than 50 percent of public assets in their charter capital, the size of remuneration is recommended to be made dependent on KPI achievement [3].

At the same time, as best corporate management practices show, relating the rates of board members compensation with short-term business results, including financial, *is not recommended*. This instruction is designed to prevent activities aimed solely at achieving short-term indicators; after all, a board of directors is a body of *strategic* management and development. Proceeding from the above, we can infer that it is a very good time to consider introducing a variable part of compensation – in addition to a fixed one – such as bonuses, awards (stock options – only for larger companies because in non-public companies this measure has proved ineffective), etc. The size of bonuses paid to CEOs of medium-sized state companies can be made subject to the growth dynamics of dividends paid to stakeholders, or to the added value growth.

It should be noted that there is always an opportunity for non-material encouragement and incentive of members of the board of directors and other corporate management bodies, such as, for instance, various programs of further education and skill upgrade, and insurance (including liability insurance for managing bodies, that in the majority of Russian companies is as yet only an exotic practice), etc. [4, 94].

Currently, evaluation criteria for the performance, effectiveness and professional skill level of members of boards of directors in state companies are established and determined by the directive No. 71, dated March 6th, 2014, of the Federal Property Management Agency: "On approval of the methods for individual evaluation of members of board of directors in joint stock companies partially owned by the state". These methods are also given in the corporate management code recommended for use by the Central Bank of the Russian Federation. The guidelines provide for regular annual evaluation of the work of the board of directors, its members and committees, along with an external evaluation of work quality once three years, which is in line with the best international practices. Unfortunately, this Code has the advisory nature and does not apply to a majority of medium-sized state companies.

4. Results

When implementing a system of evaluation for boards of directors, there arise a number of key issues:

- how often the evaluation of the performance of board of directors takes place?
- when evaluating, is an appropriate emphasis placed upon the amount of time the directors spend for work in the board?
- is the balance between theoretical knowledge and practical skills also evaluated?
- is the balance between *in presentia/in absentia* board meetings kept up in a proper way?
- is the board attendance discipline individually evaluated for *in presentia* meetings?
- how is evaluated the personal input of board/committee member in its performance?
- is the performance of board committees and other corporate management bodies also evaluated?

- are there developed and proposed any recommendations, based on the results of such evaluation, for further improvement of the corporate management processes?

- are board/audit committee member's amounts of remunerations disclosed?

Top management remuneration policy shaping. The key tasks of the committee in respect of top management compensations, in line with best corporate practices, are as follows:

- encourage and give the proper incentive to executives who show outstanding performance and results, based on general and individual evaluations;
- attraction and further retain of the best employees (top managers) motivating them to achieve corporate goals – through incentive system;
- set criteria for KPI-based incentive plans;
- approve terms and provisions for a contract with the individual executive body of the company (CEO);
- engage consulting companies to participate in solution of issues on payment of remunerations and incentive system.

Below are the key issues related to choosing and specifying methods of top management performance evaluation:

- how often is the performance of the management team evaluated?
- what types of criteria (objective/subjective) are used for top management evaluation?
- is proper attention paid to individual performance against the work of the management team as a whole?
- are education level, skill level and competencies taken into account for evaluation?
- are evaluation results made public? and do they influence over remuneration rates?

The key tasks of the human resources and compensation committee at the current stage of the corporate management development in non-public state companies are:

- establishing transparent procedures for the development of top management incentive plans;
- defining individual remuneration structure for each board member;
- ensuring non-interference of the board member in the process of defining his/her personal remuneration level;
- ensuring market remuneration rate level in order to attract and keep up members of the

board;

- creating CEO compensation plans related to his/her personal performance along with the overall performance of the company;
- one of the most essential tasks is that to find a fine balance of interests, and prevent any dominant influence of the CEO, Chairman of the Board, Stakeholder upon board members selection;
- striving to compose the committee solely of independent directors, taking into account the fact that such 'externality' or independence may be a pseudo one, including cases when independent directors are members of the 'club of irremovables', or when they consider their membership in the board as some sort of a 'honorary pension plan'.

5. Conclusion

The role of the human resources and compensation committee has become significant and practical in the recent time, with regard to the concerns expressed by investors and regulating authorities over and increased attention paid by mass media to the 'excess compensations' of members of board of directors and top managers of Russian companies partially owned by the state, particularly so in the context of Russia's stagnant economy.

We ought to note here that the Corporate Management Code recommendations being implemented currently in large state-owned companies are generally in line with the best international practices used to evaluate the performance of a board of directors and its members. But in view of the fact that the Code is advisory and in most cases has not been adopted in non-public companies partially owned by the state, so remuneration, incentive and transparency policies have to be closely monitored by the authority representing stakeholder interests – the Federal State Property Management Agency (Rosimushchestvo), along with other Federal executive bodies that are interested in the development of such companies.

The spread of the practice of selecting independent executives and professional appointees to boards of directors in state companies, coupled with the overall improvement of the corporate management culture, could initiate a transformation of the current management model in a more promising direction [5,114].

In addition to this, the introduction of more effective incentive system is capable to a considerable extent to improve the business climate/environment in companies partially owned by state and reduce the level of corporate corruption.

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