MONTENEGRIN JOURNAL OF ECONOMICS Vol. 9, No. 2 – Special Issue (May, 2013), 7-16

EXPLORING THE LINK BETWEEN EXECUTIVE COMPENSATION PACKAGE AND EXECUTIVES' PAY SATISFACTION IN CROATIAN COMPANIES: AN EMPIRICAL STUDY

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Abstract

The executive compensation package can, and most often does, contain many elements. These elements have differing effects on executive motivation and risk taking propensity, and they impose different costs for the company. In that sense, the aim of this paper is to investigate the components of executive compensation packages in large Croatian companies as well as to identify the level of executives' satisfaction with their compensation packages.

The research was conducted in 2010 via mail survey. The questionnaires were addressed to the Presidents of Management Boards of 500 of the largest Croatian companies. 72 questionnaires were collected so that overall response rate was 14.4% (which is considered to be highly acceptable having in mind the delicacy of the issue of managerial compensation).

Our research results suggest that besides base salary, other components of executive compensation package are not adequately represented. Bonus is the most common form of variable pay, whereas stock options and stock grants are not included in executive compensation packages in large Croatian companies. Even though structure of executive compensation packages in large Croatian companies is, for the most part, not in line with theoretical postulates, top managers seem to be satisfied with their pay and other elements of their compensation package.

Keywords: *Compensation package, Executives, Satisfaction.*

JEL Classification: G30; J33; M12; M52:

Original scientific paper

Received: February 03, 2012 / Accepted: Maj 13, 2013

1. INTRODUCTION

Understanding the executive compensation package and its role in the modern companies requires a basic understanding of corporate governance. In the modern companies the ownership and management functions are separated. This separation leads to principal-agent problem. In basis this problem concerns the difficulties in motivating one party (the "agent"), to act in the best interests of another (the "principal") rather than in his or her own interest. In the context of executive compensation, the issue is motivating the executive of the company (the agent) to act in the best interest of the principal (the shareholders) (Garen, 1994). The existence of this problem drives shareholders to design optimal compensation packages to provide executives with incentives to align their mutual interests (Conyon, 2006).

Additional aim of the companies is to design the compensation packages which will attract, retain, motivate and satisfy their executives (Jensen et al., 2004). So the question is which components of compensation package companies need to choose in order to design the effective compensation package. The literature indicates which components should be included in executive compensation packages in order to resolve principal-agent problem and also to obtain their motivation role.

So the aim of this paper is to explore the extent to which large Croatian companies use theory postulates when designing their executive compensation package. In other words, the aim of

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2. THEORETICAL FRAMEWORK

A well-designed executive compensation package is important because it rewards both executives and shareholders, whereas a poorly designed one, wastes corporate resources without motivating the executives. At the extreme, poorly designed incentive system can cause the executive to take actions that reduce shareholders value – for example, cutting back on long-term profitable investments to increase current compensation.

The executive compensation landscape has changed dramatically in recent years driven by the focus on shareholder value creation and the continued rise in stock markets. It is safe to say that having an effective total compensation package has never been more important to satisfy increasingly knowledgeable and vocal shareholders, directors, executives, and various political and public groups.

There are many details that must be attended to in designing the executive compensation package of any company, large, or small. These range, from relative simple questions of how closely the base salary and annual bonus reflect the market to the more arcane but significant issues surrounding stock option valuations and the latest accounting changes.

Firstly, the compensation package should be used to align the interests of shareholders and executives. Properly designed, the compensation package can be a tool for mitigating the conflict between shareholders and executives. It does so by rewarding executives for taking actions that increase shareholder value. Unfortunately, owners have incomplete information about the actions of executives. Further, they may not have the expertise to evaluate those actions, even if the actions are observable. Thus it is difficult to base compensation on actions alone. Rather, compensation is often tied to measures that are positively correlated with managerial effort, for example, accounting income share price, or market share (The WorldatWork, 2007, pp. 289). By creating a pay-performance linkage in compensation contracts, executives have more incentives to maximize shareholder wealth (Core et al., 2003). Moreover, the risks between the principals and agents can be shared more equitably (Jensen and Meckling, 1976; Cordeiro and Veliyath, 2003). In this context, Jensen and Murphy (1990) find that increases in shareholder wealth are positively related with CEO pay. Main et al. (1996) find that the relation between pay and performance becomes more significant when executive options are included in total compensation.

Secondly, compensation packages should be designed to attract, retain and motivate. In this context the expectancy theory rises up. This theory stress the importance of individual differences in designing the executive compensation package which will attract, retain and motivate the best executives. Some executives might prefer deferred compensation. Other might prefer golden parachutes as a protection against unemployment. Still others might prefer risky stock options. Some executives might even prefer nonfinancial rewards, such as time for family, sabbaticals, and a variety of other perks.

But the most important factor is that there be absolute clarity on the purpose and objectives of the compensation packages (Berger and Berger, 1999, pp. 340). One key step a company can take to achieve clarity of purpose is to articulate a meaningful compensation philosophy. The philosophy is an embodiment of organizational beliefs and values in the area of compensation practices, but it should be also a practical guide that links those values to the strategy and direction of the business, as well as a way to coherently bring together the various elements of compensation.

So the executive compensation package can, and most often does, contain many components. These components have differing effects on executive motivation and risk, as well as different cost for the company. The major and most common components of executive compensation package are: base salary, bonus, stock options, stock grants, other stock based forms of compensation, pensions, benefits and perquisites, severance payments (The WorldatWork, 2007).

Base salary is the fixed contractual amount of compensation that does not explicitly vary with performance. It takes into account the specific tasks and challenges of executives, their seniority and experience (Goergen and Renneboog, 2011). Today, in western economies the base salary is only the tip of the iceberg of total executive compensation (Hendreson, 2003). Bonus is a form of compensation that may be conditioned upon individual, group, or company performance. The performance conditions used to determine the bonus can be implicit or explicit, objective or subjective, and financial or nonfinancial. In some cases, bonuses can be based upon one factor whereas in other cases, they can be based upon a combination of factors. In addition, bonuses can be based upon short-term or long-term measures. The researches indicate that today executives have the opportunity to earn an annual bonus of up to 120% of base salary (Frydman and Jenter, 2010). Stock options as additional component of executive compensation package is the right (not obligation) to purchase a stated quantity of stock at a stipulated price (strict price) over a given period of time (exercise period) following certain eligibility (vesting) requirements (Milkovich and Newman, 2005, pp. 468). During the 1980s and especially the 1990s, in U.S., stock options surged to become the largest component of top executive pay. Today, they account for over one half of total executive compensation (Frydman and Jenter, 2010). Stock grants occur when company gives shares to their employees. They differ from stock options in that they have no exercise price. Whereas a stock option only has value if the company's share price is above the exercise price, a stock grant has value as long as the share price is above zero. Other stock based forms of compensation include stock appreciation rights, phantom stock, and equity units. Stock appreciation rights are the right to receive the increase in the value of a specified number of shares of common stock over a defined period of time. Phantom stock are units that act like common stock, but that do not constitute claim for ownership of the company. Equity units entitle the holder to purchase common stock at its book value, and then resell the stock to the corporation at its book value at a later date. Pensions are a form of differed compensation, whereby after retirement from the company, the employee receives a payment or series of payments. The researches about pensions are very rare, but there is some evidence about them. Namely, Sundaram and Yermack (2007) calculate the pension values of about 10% of total pay for Fortune 500 CEOs. Additionally, Bebchuk and Jackson (2005) discovered the significant pension values in a sample of S&P 500 CEOs. Benefits and perquisites which are also category of compensation package component usually include company car, the use of company airplanes and apartments, special dining facilities, country club membership, health, dental, medical, life and disability insurance. Rajan and Wulf (2006) report that 66% of the employers offer their executives access to the company plane, 38% chauffer service, 56% a company car, 47% country club membership, 48% lunch club membership, 17% health club membership. And finally, severance payments as compensation package component are fairly common and have become very controversial. Severance payments occur when an executive leaves the company under pressure or is fired without cause; consequently while they are sometimes included in the executive's employment contract, severance payments at most happen one at the end of the executive's tenure with the company. Yermack (2006) finds that severance payments are common, but usually moderate in value.

All these components of the compensation package have different effects on executive incentives, risk, political cost and tax payments, as well as on company financial reporting, political costs, and tax payments. More commonly compensation packages include both fixed and variable components. Fixed components are included to reduce risk to the executive and guarantee a standard of living, whereas variable components are included to provide incentives and align the interest of executives and shareholders. Assuming that the executive compensation package will include both fixed and variable components, the company has to decide how much of each to include, and what forms they should take. Fixed components might include salary and benefits, such as employer-paid life insurance, health care and pensions. Variable components might include bonuses, where the payout may be based on reported accounting numbers, market share or customer satisfaction; and stock compensation where the payout is based on stock prices. When a company is determining the variable components of its compensation package it must realize that different forms of variable compensation provide different incentives.

The company should also realize that the structure of an incentive plan can yield very specific orientation and behaviors. A bonus plan based upon accounting numbers lead to higher reported accounting income, but not necessarily lead to higher shareholder value, as executives may make cosmetic changes to its financial statements to increase its bonuses. Similarly, if executives are rewarded for increasing market share, the company may get increased market share, but at the cost of reduced profits and reduced shareholder value (The WorldatWork, 2007).

3. METHODOLOGICAL FRAMEWORK AND RESEARCH DESIGN

The research was conducted in June 2010 on the population of 500 of the largest Croatian companies (by total revenues). The Presidents of Management Boards were asked to answer series of closed format questions. 72 questioners were collected via mail survey, so that overall response rate was 14.4%. SPSS 18 for Windows was used for statistical analysis of the data collected.

For the purposes of our research, we have identified six industries: financial (15.3% of the companies in the sample), construction (19.4%), food and beverages (15.3%), trade (15.3%), manufacturing (19.4%), and other services (15.3%). By type of ownership, distribution of companies is as follows: predominantly privately-owned (62.5% of the companies in the sample), completely state-owned (12.5%), predominantly state-owned (8.3%), predominantly privately-owned, but under substantial Government influence[4] (8.3%), predominantly foreign-owned (8.3%). Companies in the sample are on average 46.8 years old (youngest company in the sample is only 4 years old, while the oldest one is 150 years old) and have on average 2.83 executives appointed to the Management Board (Board size varies from minimum one to maximum six members of Management Board). Further, just over half of the Presidents of Management Boards (56.9%) in the sample have Master of Science (arts) or doctor of philosophy academic degree, while 38.9% have university diploma. Only one respondent (1.4%) has high school diploma, while 2.8% of the respondents have college diploma. Educational background analysis by primary field of education reveals that 63.9% of the respondents have undertaken education in the field of business, while 23.6% of the respondents have undertaken education in engineering. 4.2% of the executives in the sample have undertaken education in the field of law, while other fields of education (medical studies, arts, other social studies fields) are less represented (8.3%). Additionally, the greatest proportion of respondents (48.6%) have reported tenure on current position (President of Management Board) up to 5 years, while third of the respondents have reported tenure longer than 5 years but lesser than 10 years (33.3%). 12 respondents (16.7%) have reported tenure longer than 10 years.

4. RESULTS AND DISCUSSION

Since variable pay is an important reward element, we analyzed variable pay of Presidents of Management Boards of Croatian companies in the sample (Table 1). The results of our research clearly demonstrate that variable pay is inadequately represented reward element in compensation package of Croatian top managers. Almost half of the Presidents of Management Boards from our research sample (48.5%) have reported proportion of variable pay lesser than 5%, while only two Presidents (2.9%) have reported share of variable pay that exceeds 50%. On the other hand, there is almost equal distribution of respondents whose variable pay proportion in compensation package varies from 5% to 10% (14.7% of the respondents), from 10% to 20% (16.2% of the respondents) and from 20% to 50% (17.6% of the Presidents of Management Boards in the sample). Having in mind that our research sample was drawn out of the population of 500 largest Croatian companies by total revenues, presented figures not only are insufficient but also in collision with global trends in executive compensation.

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[4] In Croatia, as well as in other (post) transition countries, this is not unusual in strategically important sectors such as energy sector or shipbuilding industry.

Table 1: Distribution of Presidents of Management Boards by proportion of variable pay

		Frequency	*Percent*	*Valid percent*
Valid	Less than 5%	33	45.8	48.5
	5% to 10%	10	13.9	14.7
	10% to 20%	11	15.3	16.2
	20% to 50%	12	16.7	17.6
	More than 50%	2	2.8	2.9
	Total	68	94.4	100.0
Missing	System	4	5.6	
Total		72	100.0	

Next, we were interested in the most frequent form of variable pay in our research sample. Results in Table 2 show that just over three quarter of the respondents (77.8%) have reported receiving bonus as a form of variable pay, while 20% of the respondents have reported to participate in a profit-sharing scheme. Only one President of Management Board (2.2%) has reported compensation in stock options as a form of awarding. While most of the respondents felt free enough to report the actual proportion of their variable pay in overall compensation package (94.4% of the respondents answered when being asked about proportion of variable pay), they seem to be not responsive enough when being asked about the form of variable pay (37.5% missing observations).

Table 2: Distribution of Presidents of Management Boards by type of variable pay

		Frequency	*Percent*	*Valid percent*
Valid	Bonus	35	48.6	77.8
	Stock options	1	1.4	2.2
	Profit-sharing	9	12.5	20.0
	Total	45	62.5	100.0
Missing	System	27	37.5	
Total		72	100.0	

Further, we analyzed if managerial contracts of top executives in the research sample include severance pay (Table 3). Just under two thirds of the respondents (63.1%) said that their contract include severance pay, while 36.9% of the respondents have reported no severance pay included in their contract.

Table 3: Distribution of Presidents of Management Boards by severance pay

		Frequency	*Percent*	*Valid percent*
Valid	No	24	33.3	36.9
	Yes	41	56.9	63.1
	Total	65	90.3	100.0
Missing	System	7	9.7	
Total		72	100.0	

As a next level of analysis, we examined if managerial contracts of Presidents of Management Boards in the sample include any additional benefits, namely life insurance programs or pension programs. Results presented in Table 4 show that 65.6% of top executives in the sample have no additional benefits included in their contract, while 34.4% of respondents have reported to have life insurance programs or pension programs as a part of their managerial contract.

Table 4: Distribution of Presidents of Management Boards by additional benefits (life insurance programs/pension programs)

		Frequency	*Percent*	*Valid percent*
Valid	No	42	58.3	65.6
	Yes	22	30.6	34.4
	Total	64	88.9	100.0
Missing	System	8	11.1	
Total		72	100.0	

Next, we were interested to find out if Presidents of Management Boards in large Croatian companies included in the research sample receive rewards (and incentives) in the form of managerial ownership. Results presented in Table 5 suggest that third of the respondents participate in ownership structures of their companies, while 66.7% of the respondents are not participating in managerial ownership scheme.

Table 5: Distribution of Presidents of Management Boards by managerial ownership

		Frequency	*Percent*	*Valid Percent*
Valid	No	46	63.9	66.7
	Yes	23	31.9	33.3
	Total	69	95.8	100.0
Missing	System	3	4.2	
Total		72	100.0	

In case that top managers participate in ownership structure (Table 6), most often they report 5% or lesser equity share (47.8% of the respondents). Just over quarter of respondents (21.7%) have reported substantial participation in ownership (20% to 50%), while respectable number of respondents (17.4%) has reported dominant position in ownership structure (more than 50%). Only one respondent reported participation in ownership in range from 5% to 10%.

Table 6: Distribution of Presidents of Management Boards by proportion of share ownership

		Frequency	*Percent*	*Valid Percent*
Valid	Less than 5%	11	15.3	47.8
	5% to 10%	1	1.4	4.3
	10% to 20%	2	2.8	8.7
	20% to 50%	5	6.9	21.7
	More than 50%	4	5.6	17.4
	Total	23	31.9	100.0
Missing	System	49	68.1	
Total		72	100.0	

Since compensation package satisfaction is one of the important facets of overall job satisfaction and is closely related to structure and quality of overall compensation package, we asked respondents to rate their compensation package satisfaction level (relatively to other Management Board members' compensation packages in their industry). Research results presented in Table 7 show that just over half executives in the sample (55.7%) are satisfied with pay and other elements of compensation package, while respectable proportion (28.6%) of executives have reported neutral feelings toward compensation package satisfaction (not satisfied, but not even dissatisfied with pay and other elements of compensation package). 8.6% of respondents have reported to be very satisfied with compensation package, while on the other hand we have identified 7.1% of the respondents who are dissatisfied or very dissatisfied with compensation package (when comparing themselves to other executives in their industry).

Table 7: Distribution of Presidents of Management Boards with respect to compensation package satisfaction level

		Frequency	*Percent*	*Valid Percent*
Valid	Very dissatisfied	1	1.4	1.4
	Dissatisfied	4	5.6	5.7
	Not satisfied, nor dissatisfied	20	27.8	28.6
	Satisfied	39	54.2	55.7
	Very satisfied	6	8.3	8.6
	Total	70	97.2	100.0
Missing	System	2	2.8	
Total		72	100.0	

We have analyzed respondents' compensation package satisfaction level according to ownership structure. Results of analysis of variance (ANOVA) show that the difference between compensation package satisfaction level with respect to type of ownership is not statistically significant (F=1,844, df=4, sig.=.131), even though descriptively observable. Our findings demonstrate that compensation package satisfaction level is highest in predominantly state-owned companies (4.00), while is lowest in completely state-owned companies (3.11). This could mean that privatization processes, as answer to the failure of state ownership, are positively related to compensation package satisfaction of executives in partially privatized firms.

As for the post hoc ANOVA (LSD) test results, executives in predominantly privately-owned companies are significantly more satisfied with pay and other elements of compensation package than executives in completely state-owned companies (sig.=.031). Furthermore, the level of compensation package satisfaction of executives in predominantly state-owned companies is significantly higher than the level of compensation package satisfaction of executives in completely state-owned companies (sig.=.041).

Analyzing compensation package satisfaction level of Presidents of Management Boards in Croatian companies in the sample with respect to tenure for the current position, we determined statistically significant difference between compensation package satisfaction levels with respect to tenure for the position (F=2,899, df=3, sig.=.042). As a further level of analysis, we determined that compensation package satisfaction level is highest for Presidents of Management Boards who are on the current position for more than ten years (4.17), while the level of compensation package satisfaction is lowest for reported tenure lesser than one year (3.33).

Table 8: The level of Presidents' of Management Boards compensation package satisfaction with respect to type of ownership

	N	*Mean*	*Std. Dev.*	*Std. Error*	*95% Confidence Interval for Mean*		*Min*	*Max*
					Lower Bound	Upper Bound		
Predominantly privately-owned	44	3.73	.758	.114	3.50	3.96	1	5
Completely state-owned	9	3.11	.782	.261	2.51	3.71	2	4
Predominately state-owned	5	4.00	1.000	.447	2.76	5.24	3	5
Predominantly privately-owned, but under substantial Government influence	6	3.33	.816	.333	2.48	4.19	2	4
Predominantly foreign-owned	6	3.83	.408	.167	3.40	4.26	3	4
Total	70	3.64	.781	.093	3.46	3.83	1	5

POST HOC ANOVA TEST (LSD)

(I) Ownership	(J) Ownership	*Mean difference (I-J)*	*Std. Error*	*Sig.*	*95% Confidence Interval for Mean* Lower Bound	Upper Bound
Completely state-owned	Predominantly privately-owned	-,616*	,279	,031	-1,17	-,06
	Predominately state-owned	-,889*	,425	,041	-1,74	-,04

* The mean difference is significant at the 0.05 level.

Table 9: The level of Presidents' of Management Boards compensation package satisfaction with respect to tenure for the current position

	N	*Mean*	*Std. Dev.*	*Std. Error*	*95% Confidence Interval for Mean* Lower Bound	Upper Bound	*Min*	*Max*
Less than 1 year	9	3.33	1.000	.333	2.56	4.10	1	4
1 to 5 years	25	3.68	.690	.138	3.40	3.96	2	5
5 to 10 years	22	3.45	.800	.171	3.10	3.81	2	5
More than 10 years	12	4.17	.577	.167	3.80	4.53	3	5
Total	68	3.65	.787	.095	3.46	3.84	1	5

POST HOC ANOVA TEST (LSD)

(I) Tenure on the position	(J) Tenure on the position	*Mean difference (I-J)*	*Std. Error*	*Sig.*	*95% Confidence Interval for Mean* Lower Bound	Upper Bound
More than 10 years	Less than 1 year	,833*	,333	,015	,17	1,50
	1 to 5 years	,487	,265	,071	-,04	1,02
	5 to 10 years	,712*	,271	,011	,17	1,25

* The mean difference is significant at the 0.05 level.

Results of post hoc ANOVA test (LSD) show that Presidents of Management Boards who are occupying current position for more than 10 years have a significantly higher level of compensation package satisfaction compared to Presidents of Management Boards occupying current position for less than 1 year (sig.=.015), compared to executives who are on the current position from 1 to 5 years (even observed differences are being statistically significant only at the 10% level – sig.=.071), and compared to managers who are on current position from 5 to 10 years (sig.=.011).

We also tested differences in compensation package satisfaction with respect to managerial ownership. Participation in ownership by leading executives is an object of many controversies. It is an important incentive alignment mechanism that reduces agency problem while at the same time improves company's efficiency. Even if managerial ownership – efficiency relationship is controversial in many ways, available empirical findings suggest that managerial ownership undoubtedly increases managerial discretion and power and contributes managerial entrenchment by reducing the odds of inefficient top managers' replacement.[5]

[5] Even in Croatian settings, the nature of managerial ownership-efficiency relationship remains (for the most parts) unclear, but managerial ownership significantly reduces chances of replacement (dismissal) of poorly performing managers. See more in Tipurić, D., Slišković, T., Daraboš, M. (2011): Menadžersko dioničarstvo, djelotvornost poduzeća i

Table 10: The level of Presidents' of Management Boards compensation package satisfaction with respect to managerial ownership

	Participation in ownership	*N*	*Mean Rank*	*Sum of Ranks*
Pay satisfaction	No	46	31,49	1448,50
	Yes	23	42,02	966,50
	Total	69		

Test Statistics[a]

	Pay satisfaction
Mann-Whitney U	367,500
Wilcoxon W	1448,500
Z	-2,287
Asymp. Sig. (2-tailed)	,022

a. Grouping Variable: Participation in ownership

Results of our research clearly demonstrate that there is statistically significant difference between compensation package satisfaction levels with respect to managerial ownership (Z= -2,287, sig.=.022 for Mann-Whitney test), whereas participation in ownership contributes to lower levels of compensation package satisfaction of Presidents of Management Boards in the sample.

5. CONCLUSION

The motivation behind this paper was to investigate and critically evaluate the components of executive compensation packages in large Croatian companies as well as to identify the extent to which large Croatian companies use theoretical prescriptions when designing executive compensation packages. Our research results show that the most used components of executive compensation package in large Croatian companies are severance pays and bonuses. Stock options and stock grants are not adequately represented in their compensation packages. Regarding the satisfaction with compensation packages, research results show that the majority of executives are satisfied with their compensation packages. Furthermore, the research results indicate that there is a statistically significant difference in the level of executives' satisfaction with compensation package regarding the ownership structure whereas the compensation package satisfaction level is highest in predominantly state-owned companies. Also, we found statistically significant differences in the level of satisfaction with the compensation package regarding tenure on the position of the President of Management Board whereas compensation package satisfaction level is highest for managers occupying their positions for more than 10 years. Finally, our research results demonstrate that managerial ownership contributes to lower levels of compensation package satisfaction.

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