Managerial Compensation and Financial Performance

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A Pragmatic Guide

By

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PREFACE

The economic landscape of India has undergone significant transformations over the past few decades, emerging as one of the fastest-growing major economies in the world. Central to this economic growth is the manufacturing sector, which has not only contributed substantially to the GDP but has also been a key driver of employment and innovation. As the sector continues to evolve, one of the pivotal factors that influence its success is the compensation of its managerial workforce.

Managerial compensation, encompassing salaries, bonuses, stock options, and other benefits, is designed to attract, retain, and motivate top talent. It plays a crucial role in aligning the interests of managers with those of the shareholders. The structure and level of compensation can have significant implications for a company's strategic direction, operational efficiency, and overall performance.

In the context of India, the design and regulation of managerial compensation have been influenced by various factors, including economic reforms, corporate governance standards, and market dynamics. The liberalization policies of the 1990s opened up the economy, leading to increased competition and the need for more sophisticated management practices. This, in turn, has impacted how companies structure their compensation packages to stay competitive.

Financial performance is typically assessed through various metrics such as profitability, return on assets, return on equity, and market valuation. These metrics provide insights into a company's operational efficiency, financial health, and shareholder value creation. In the manufacturing sector, specific performance indicators such as production efficiency, cost control, and innovation output are also critical.

The relationship between managerial compensation and financial performance is complex and multifaceted. On one hand, well-structured compensation packages can incentivize managers to pursue strategies that enhance profitability and growth. On the other hand, excessive or poorly designed compensation can lead to short-termism, risk-taking, and even ethical lapses.

India's manufacturing sector presents a unique blend of opportunities and challenges. The government's "Make in India" initiative aims to transform the country into a global manufacturing hub, emphasizing the importance of manufacturing for economic development. However, the sector also faces hurdles such as regulatory compliance, infrastructure deficits, and the need for technological upgrades.

In this dynamic environment, the role of managerial compensation becomes even more critical. Effective compensation strategies can help attract the best talent, drive innovation, and ensure that managerial actions are aligned with the long-term objectives of the company.

This study aims to explore the intricate relationship between managerial compensation and the financial performance of manufacturing companies in India. By examining various compensation structures and their impact on performance metrics, the research seeks to provide insights that can inform policy-making, corporate governance practices, and strategic management decisions.

The scope of the study includes a comprehensive analysis of publicly listed manufacturing companies in India, covering a diverse range of sub-sectors such as automotive, textiles, chemicals, and consumer goods. The research methodology involves quantitative analysis of financial data, supplemented by case studies.

Understanding the link between managerial compensation and financial performance is crucial for the sustainable growth of the manufacturing sector in India. As the sector continues to navigate the complexities of a globalized economy, strategic compensation practices will be key to fostering managerial excellence, driving innovation, and enhancing competitiveness.

This study aims to contribute to the ongoing discourse on corporate governance and performance management, providing valuable insights for academics, practitioners, and policymakers. Through rigorous analysis and thoughtful discussion, it seeks to highlight the best practices and potential pitfalls in designing compensation strategies that can propel India's manufacturing sector to new heights.

We extend our deepest gratitude to the professors of the Department of Commerce and the Department of Business Administration for their continuous encouragement, to our family members for their unwavering support, and to our publisher for their steadfast commitment to bringing this book to fruition.

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ABBREVIATIONS

MCOMP .... Managers' compensation
All_PER...Allowances and perquisites
INCENT ....Incentive
S_OPT .... Stock option
O_COMP...Other part of compensation
ROA .... Return on Assets
RONW...Return on Net Worth
M_CAP...Market Capitalisation
ENT_VALUE/...Enterprise Value
B_SIZE...Board Size
B_IND ....Board Independence
B_MEET .... Board Meeting
FII .... Foreign Institutional Investment
IIS ....Indian Institutional Shareholding
PS .... Promoters' Shareholdings
EXP .... Expenses
D/E ....Debt-to-Equity Ratio
CEO .... Chief Executive Officer

CHAPTER ONE

INTRODUCTION

1.1 Managerial Compensation: Backdrop

After liberalisation, privatisation and globalisation (LPG), significant changes have taken place in the concept of managerial compensation. In India, managerial compensation has garnered increasing attention since the introduction of economic liberalisation. The compensation for managerial personnel has sharply increased since 1994, making it easily distinguishable from that of non-managerial personnel. In India, managerial compensation is considered from both economic and regulatory perspectives. Accordingly, boards have considered both the hike in compensation and adoption of regulatory norms to retain the managerial talents in their organisation.

After the reforms, the explicit increase in salary level and the extensive regulatory norms have been taken into consideration by boards to fix payments for managerial personnel. This has also stimulated concern regarding the performance of incentives offered to managerial talents to reduce agency costs. In India, from an economic point of view, one of greatest concern is horizontal agency costs, which arise between controlling minority shareholders and other shareholders. Horizontal agency costs differ from vertical agency cost, which arise between managers and dispersed shareholders; these are the main causes behind high managerial pay among widely accepted Anglo-American listed companies.

In large companies, there is a separation between management and ownership. The decision-making authority in a company lies in the hands of managers. Owners expect managers to act in the best interests of shareholders, but, in practice, managers may not necessarily act in the best interest of shareholders and may pursue their own personal goals. The conflict between the interests of shareholder and managers is referred to as agency conflict. This conflict can be mitigated when managers are offered ownership rights through stock options. Owners can also offer attractive monetary and non-monetary incentives to managers to act in their interest.

In India, like other sectors, the manufacturing sector has also undergone several changes. In any industry or business organisation, managerial personnel play a crucial role because they are responsible for the success company. They act as the backbone of any organisation. Without these personnel, no company can run properly and systematically. They are hard to achieve business prosperity, continuous improvement, and success and in return, they receive a reward known as managerial compensation. These managerial personnel receive a highly appreciated compensation package for their enormous efforts and for holding positions in the organisation.

In the past, most organisations tended to keep information regarding their managerial compensation packages secret and confidential. They did not want to disclose it openly. However, now-a-days, it is more transparent and easily accessible. Today's companies are very concerned about balancing their managerial compensation costs and retaining their managerial personnel. The right compensation package along with the right kind of opportunities makes the difference between satisfied and disappointed managerial personnel. Getting the right compensation is a motivating factor by itself. It is a tool that encourages values and culture. It is also an instrument that helps an organisation achieve its goals and objectives.

Managerial compensation depends on various factors, such as qualification, experience, attitude, prevailing rates in the market. It is a complex and controversial topic. Academicians, policy makers and the media have drawn attention to the high levels of pay awarded to managerial personnel.

1.2 Features of Managerial Compensation

- Managerial compensation is related to organisational performance, not individual performance.
- Managerial compensation is subject to statutory norms.
- Their compensation cannot be compared with the wage and salary packages of other employees.
- Managerial talents do not agree with the union power in fixing compensation.
- Compensation also depends on general market conditions.

- Secrecy should be maintained while fixing managerial compensation.
- The shortage of talented managerial personnel plays a crucial role in framing the actual compensation package.

1.3 Objectives of Managerial Compensation

It has been argued that managerial compensation should be based on the performance of the firm. A stronger pay-performance relation helps to retain talented and dynamic managers, but it is difficult to select managers. Agency theory states that compensation should be planned in such a way that aligns the interests of managers (agents) with those of shareholders (principals).

- Managerial compensation should encourage and motivate managerial personnel towards achieving organisational goals.
- Every manager should receive compensation based on their talents, qualification, performance and efficiency.
- Managerial compensation should be provided in the form of a package.
- The compensation package should be flexible and clear enough to understand.

1.4 Determination of Managerial Compensation

Each company has a set of strategic goals. Managerial compensation is uniquely designed to meet these goals. Every managerial personnel's working style leads to different compensation level. Managerial compensation is fixed in the form of financial returns, tangible services, and benefits received from the company. Generally, compensation payable to managerial personnel comprises various components, such as fixed pay, variable pay and others. Some important factors that affect managerial compensation include:

1. **Age:** The age of managerial personnel is direct linked to their experience, communication and other skills.
2. **Firm Size:** Firm size is a significant factor that affects managerial compensation. Firm size, closely associated with market determines the managerial compensation.
3. **Board Size:** The size of the board may affect managerial compensation. Larger board size may lead to higher compensation due to the managers seeking new job opportunities. Board structure is an important control mechanism for fixing managerial compensation.

4. **Legal Provisions:** The compensation of managerial personnel is covered under the Companies Act, 2013. Total remuneration to managerial personnel is based on the company's earning capacity. Legal provisions of the Companies Act determine the managerial compensation.
5. **Ownership of the Shareholders:** The concentration of shareholders may also affect managerial compensation. The presence of a large number of shareholders tends to lower managerial compensation.
6. **Growth:** Market value, based on growth or investment opportunities, also influences managerial compensation.
7. **Integrity:** The integrity of managerial personnel is another useful factor in determining their compensation.

Some researchers have studied the effect of personal characteristics of managerial talents, such as age, qualifications, experience, on their compensation. Other researchers have examined the role of market forces in determining managerial compensation. Domestic companies usually pay more to their managerial personnel by following the practices of their rivals and international companies. However, the actual compensation level depends mainly on corporate laws. Legal regulations set the limits under which the above-mentioned variables determine managerial pay packages. Due to legal provisions in the corporate sector, managerial compensation is determined in almost all nations by the Compensation Committees involving independent directors and professional experts.

The above discussion indicates that determining managerial compensation is not straightforward. Compensation should be fixed in the light of the legal structure while considering the company level of managerial talents, organizational culture, and performance and pay practices adopted in the industry in which the company is operates.

1.5 Importance of Managerial Compensation

Managerial talents play a critical role in a company as they are the strategists and decision-makers. Therefore, it is the company's duty to keep these talents motivated and satisfied through the right benefits package. The importance of managerial compensation includes:

- ***Compensation management makes a company cautious:*** It drives managers to recognise star performers and appreciate their efforts, ultimately lower the risk of losing valuable employees.

- ***Compensation management* is positive reinforcement:** Cash prizes and regular monetary perks, along with an excellent work atmosphere, allow companies to grow rapidly through motivated, inspired and hardworking employees.
- **Compensation management enhances the company's goodwill:** When employees are satisfied with their tangible and intangible benefits, they attract better prospects to fill vacant positions and help bring new, fresh talent to the organization.

CHAPTER TWO

REGULATORY FRAMEWORK FOR MANAGERIAL COMPENSATION

2.0 Regulatory Framework for Managerial Compensation

In the Indian context, the regulatory framework on the pay-package of managerial personnel has experienced significant implications. The Notification of the Companies Act, 2013 and the revisions made in Clause 49 of the Listing Agreement, 2014 by the Securities and Exchange Board of India (SEBI) have introduced substantial changes in the determination and disclosure of managerial compensation.

2.1 Key Managerial Personnel: Concept

The Companies Act, 2013 has defined the concept of Key Managerial Personnel for the first time. As per Clause (51), Section 2 of the Act, Key Managerial Personnel in relation to a company refers to: (i) The Chief Executive Officer or the managing director or the manager; (ii) The company secretary; (iii) The whole-time director; (iv) The Chief Financial Officer; and (v) Such other officer as may be prescribed.

Chief Executive Officer: Chief Executive Officer under Section 2(18) of the Companies Act, 2013 is a person selected as the Chief Executive Officer of a company.

Managing Director: According to Section 2(54) of the Companies Act, 2013, a Managing Director is a director who is accountable for substantial powers of the management of the company and its affairs and is selected by an agreement or a declaration passed in its general meeting.

Manager: Section 2(53) of the Companies Act, 2013 defines a Manager as any individual who works under the control and direction of the Board of Directors and is entrusted with the management of the entire affairs of the company.

Company Secretary: As per Section 2(24) of the Companies Act, 2013, the function of the Company Secretary is to report to the Board about the compliance of the provisions of the Act and other rules related to this Act. It also ensures whether the company is complying with the secretarial standards.

Whole-Time Director: The Whole-Time Director of a company is defined under Section 2(94) of the Companies Act, 2013, which means a director in full-time employment of the company.

Chief Financial Officer: According to Section 2(18) of the Companies Act, 2013, a Chief Financial Officer is a person who leads the finance and treasury functions of a business enterprise and is not engaged in any other manner (retainer or consultant) or by any other designation.

2.2 Applicability of Key Managerial Personnel

Prescribed companies under section 203(1) of the Companies Act, 2013 read with Rule 8 and Rule 8A of Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, are applicable to:

- Every listed company.
- Every other public company having a paid-up share capital of Rs. 10 crore or more shall have whole-time Key Managerial Personnel.
- Every private company which has a paid-up share capital of Rs. 10 crore or more shall have whole-time Key Managerial Personnel.

According to section 203(1) of the Companies Act, 2013, the above-mentioned prescribed companies shall have the following whole-time Key Managerial Personnel: (i) Managing Director (MD), or Chief Executive Officer (CEO) or manager and in their absence, a whole-time director (WTD); (ii) Company Secretary (CS); and (iii) Chief Financial Officer (CFO).

Exceptions: An individual shall not be appointed or re-appointed as the chairperson of the company, in pursuance of the articles of the company, as well as the MD or CEO of the company at the same time after the date of commencement of this Act unless: (a) The articles of such a company provide otherwise; or (b) The company does not carry on multiple businesses.

However, this exception shall not apply to such public companies: (a) Having paid-up share capital of Rs. 100 crore or more, and (b) Annual turnover of Rs. 1000 crore or more, which are engaged in multiple businesses and have appointed one or more CEOs for each such business as may be notified by the Central Government (Ministry of Corporate Affairs (MCA) notification; MCA notification No. S.O. 1913 (E) dated 25th July 2014).

2.3 Appointment of Key Managerial Personnel

- Section 203(2) of the Companies Act, 2013 says that Key Managerial Personnel can be selected by a Board resolution containing the terms and conditions of appointment including their remuneration.
- Section 203(3) of the Companies Act, 2013 says that a whole-time Key Managerial Personnel shall not hold office in more than one company excluding its subsidiary company at the same time.

Exceptions: (i) A Key Managerial Personnel can be a director of any company with the consent of the Board of Directors. (ii) Whole-time Key Managerial Personnel holding office in more than one company at the same time on the date of commencement of this Act, within a time frame of 6 months of such commencement, shall select one company in which he/she wishes to continue to hold the office of Key Managerial Personnel. (iii) A company may appoint or employ a person as its MD if he is the MD or manager of one, and of not more than one, and such appointment or employment is made or accepted by a Board Resolution with the consent of all the directors present at the meeting (i.e., Unanimous Resolutions) and of which meeting, and of the resolution to be moved thereat, specific notice has been given to all the directors then in India.

2.4 Vacancy of Key Managerial Personnel

Section 203(4) of the Companies Act, 2013 says that if the office of whole-time Key Managerial Personnel is vacated, such vacancy shall be filled up within 6 months of such vacancy by constituting a board meeting.

2.5 Other Provisions Regarding the Appointment of Key Managerial Personnel

Section 196 of the Companies Act, 2013 provides the provision for the appointment of Managing Director, Whole-Time Director, or Manager:

- No company shall appoint or employ a managing director and a manager at the same time.
- A Managing Director, Whole-Time Director, or Manager shall not be appointed for more than 5 years at a time.
- Re-appointment can be made for the next term before the expiry of their present term but not earlier than 1 year before the expiry.
- No company shall appoint or continue the employment of any person as managing director, whole-time director, or manager who: a) Is below the age of 21 years or has reached the age of 70 years; b) Is an undischarged insolvent or has at any time been adjudged as an insolvent; c) Has a record of holding payments to his/her creditors; or d) Has at any time been convicted by a court of an offense and sentenced for a period of more than 6 months.
- A person who has attained the age of 70 years can be appointed by passing a special resolution.
- In a case where no such special resolution is passed but a majority of votes are in favor, the board may apply to the Central Government, and if the Central Government is satisfied that such appointment is beneficial to the company, then it may approve the same.

2.6 Roles and Responsibilities of Key Managerial Personnel

The management function of implementing important decisions comes under the responsibilities of Key Managerial Personnel. Here are some of the main roles and responsibilities of Key Managerial Personnel:

- As per Section 170 of the Companies Act, 2013, the details of securities held by the Key Managerial Personnel in the company or its holding, subsidiary, a subsidiary of the company, or associated companies should be disclosed and recorded in the register of the books.

- Key Managerial Personnel have a right to be heard in the meetings of the Audit Committee while considering the Auditor's Report; however, they do not have the right to vote.
- According to Section 189(2), Key Managerial Personnel should disclose to the company, within 30 days of appointment, their concern or interest in other associations, which are required to be included in the register.

2.7 Ceiling Limit

Section 197 of the Companies Act, 2013 mentions the maximum limit for payment of managerial compensation by a public company to its managing director, whole-time director, and manager, which shall not exceed 11% of the net profit of the company in that financial year computed in accordance with Section 198 except that the compensation of the directors shall not be deducted from the gross profits. Further, the company in a general meeting may, with the approval of the Central Government, authorize the payment of compensation exceeding 11% of the net profits of the company, subject to the provisions of Schedule V. The net profits for the purposes of this section shall be computed in the manner referred to in Section 198.

There are limits for non-executive directors also. If the company has a managing director or whole-time director or a manager, then the compensation of non-executive directors is 1% of net profits; if the company has no managing director or whole-time director or a manager, then 3% of net profits.

2.8 Remuneration above the Limits

A company may pay remuneration in excess of the limits specified in Section 197 and Schedule V of the Companies Act, 2013, in the following situations:

- Shareholders approve the same through Special Resolution.
- Where the company has defaulted in payment of dues to any bank or public financial institution or non-convertible debenture holders or any other secured creditor, the prior approval shall be obtained by the company before obtaining the approval in the general meeting.

2.9 What is Not Included in the Limits for Remuneration?

- Professional Services: Remuneration payable to a director shall be exclusive of the remuneration payable to him for services rendered of a professional nature and the director possesses the requisite qualification for the practice of the profession.
- Sitting Fees: Any fees payable to directors for attending meetings of the Board and Committee provided that the amount of such fees shall not exceed the amount as may be prescribed.
- 2.10 Circumstances when a Company may Pay Excess Remuneration than the Amounts Provided in Section II
- If it is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in a general meeting to make such payment and comply with the provisions of Section 197 and treat such amount as managerial remuneration payable by such other company to its managerial persons or other directors.
- The company is a newly incorporated company, for a period of 7 years from the date of its incorporation.
- The company is a sick company, for which a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction, for a period of 5 years from the date of sanction of the scheme of revival.
- The company is a company in relation to which a resolution plan has been approved by the NCLT under the IBC Code, 2016 for a period of 5 years from the date of such approval; it may pay any remuneration to its managerial persons or other directors.