A STUDY ON KEY MANAGEMENT COMPENSATION

CFA SOCIETY INDIA - ADVOCACY COMMITTEE

ASHWINI DAMANI, CFA

ALEKHYA NAG, CFA

RAJENDRA KALUR, CFA

This is just a study and not any conclusion/advise on any investment. Our purpose is to just present facts. No investment decision should be taken based on this study.
All opinions and finding are just interpretations of the Authors and can be open to debate. There is no attempt to malign or misrepresent any company.

CFA Society India

INDEX

EXECUTIVE SUMMARY (1/2)

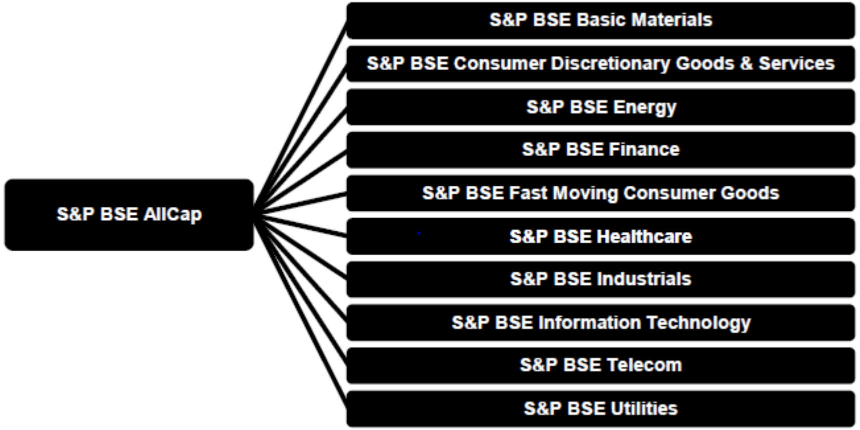
- The research reviews key trends/ observations in Key Managerial Personnel (KMP) remuneration of Indian companies. Since India has well defined laws, there is no legal issue with respect to KMP Remuneration. However there have been specific instances and softer aspects (case studies listed), may be due to loopholes and less strict approach adopted by a company's remuneration committee.
- As per Section 197 of Companies Act, 2013, companies with more than one KMP and profitable, are expected to pay not more than 11% of Net Profit as KMP remuneration. For most of the BSE 200 companies, Total Directors Remuneration as a Percentage of PBT is in the range of 0%-2%, quite lower than the ceiling of 11%. Additionally, for BSE 200 companies, Total Directors' Remuneration is increasingly getting less linked to company's performance with mix of bonus & commissions, in Total Directors' Remuneration, decreasing by 500bps over the past five years. The same trend of Total Directors' Remuneration mix getting less linked to company's performance has been observed for most of the BSE sector indexes.

EXECUTIVE SUMMARY (2/2)

- **Key Softer Aspects/ Observations (based on review of BSE 200 companies, case studies listed):**
  - KMP remuneration was capped due to investor pressure and not due to pro-active approach of Board/Committee
  - Companies where promoters take the remuneration within the limit; but take home every single rupee of the maximum remuneration allowed by the law while value-added by them may not mandate such a high remuneration
  - Some loopholes used in calculation of net profit/ KMP remuneration limit as per section 198 of companies act 2013. Additionally, some companies don't even disclose KMP Remuneration limit
  - Not mentioning Salary of key Employees as per Rule 5(2) and 5(3)
  - Paying money through subsidiaries
- **Key Conclusions:**
  - Excessive executive remuneration, not linked with performance, is a growing problem in companies in India
  - Company's remuneration committee must act as per its mandate in letter and spirit; Other stakeholders must be able to provide the necessary checks and balances, for better oversight/ risk management

RESEARCH METHODOLOGY

- Used Prowess database for drawing insights regarding KMP remuneration based on past five financial years data (FY15-FY19). For broader trends regarding listed companies, have considered BSE 200 index which covers 85% of the market cap of the listed BSE universe. Additionally for sector-wise trends, have considered BSE sector indices which seek to measure 10 economic sectors within the Indian equity market



- For specific instances and softer aspects regarding KMP remuneration, listed key observations based on review of BSE 200 companies

REMUNERATION – MEANING AND TYPES OF MANAGERIAL PERSONNEL

- As per Sec. 2(78), remuneration means any money or its equivalent given or passed to any person for services rendered by him and includes perquisites as defined under the Income-tax Act, 1961.
- Managerial remuneration in simple words is the remuneration paid to managerial personnel.
- Here, managerial personnel mean directors including managing director, whole-time director, and manager.

Managing Director

As per **Section 2(54) of Companies Act, 2013,** Managing Director means a director who, by virtue of the articles of a company or an agreement with the company or a resolution passed in its general meeting, or by its Board of Directors, is entrusted with substantial powers of management of the affairs of the company and includes a director occupying the position of managing director, by whatever name called.

Whole-time Director

Under **Section 2 (94) of Companies Act, 2013,** Whole Time Director means a director in the whole-time employment of the company. In other words, a director employed to devote the whole of his time and attention in the carrying on of the affairs of the Company.

Manager

As per **Section 2(53) of Companies Act, 2013** defines "**manager**" as an individual who, subject to the superintendence, control and direction of the Board of Directors, has the management of the whole, or substantially the whole, of the affairs of a **company**, and includes a director or any other person occupying the position of a manager, by whatever name called, whether under a contract of service or not.

REMUNERATION – RULES AND DISCLOSURES

- **However the company in general meeting may, by passing Special Resolution, authorize the payment of excess remuneration**
- Every listed company shall disclose in the Board's report, the ratio of the remuneration of each director to the median employee's remuneration and such other details as may be prescribed
- It shall also disclose
  - all elements of remuneration package such as salary, benefits, bonuses, stock options, pension, etc., of all the directors;
  - details of fixed component. and performance linked incentives along with the performance criteria;

- The Board of Directors of every listed company and such other class or classes of companies, are required to constitute a Nomination and Remuneration Committee
  - consisting of three or more non-executive directors
  - out of which not less than one-half shall be independent directors.

PERMISSIBLE REMUNERATION PAYABLE UNDER COMPANIES ACT 2013 – SECTION 197

Condition	Maximum Remuneration payable in any financial year
Company with 1 MD/WTD/Manager	5% of the net profits of the company
Company with >1 MD/WTD/Manager	10% of the net profits of the company
Overall Limit on Managerial Remuneration	11% of the net profits of the company
Remuneration payable to directors who are neither MDs nor WTDs	
For directors who are neither MD nor WTD	1% of the net profits of the company **if there is a MD / WTD or Manager**
If there is a director who is neither MD nor WTD	3% of the net profits of the company **in any other case**

- Net Profit of the company for that financial year should be computed as per Section 198
- Total remuneration including Managerial Personnel shall not exceed 11% of Net Profit

CFA Society India

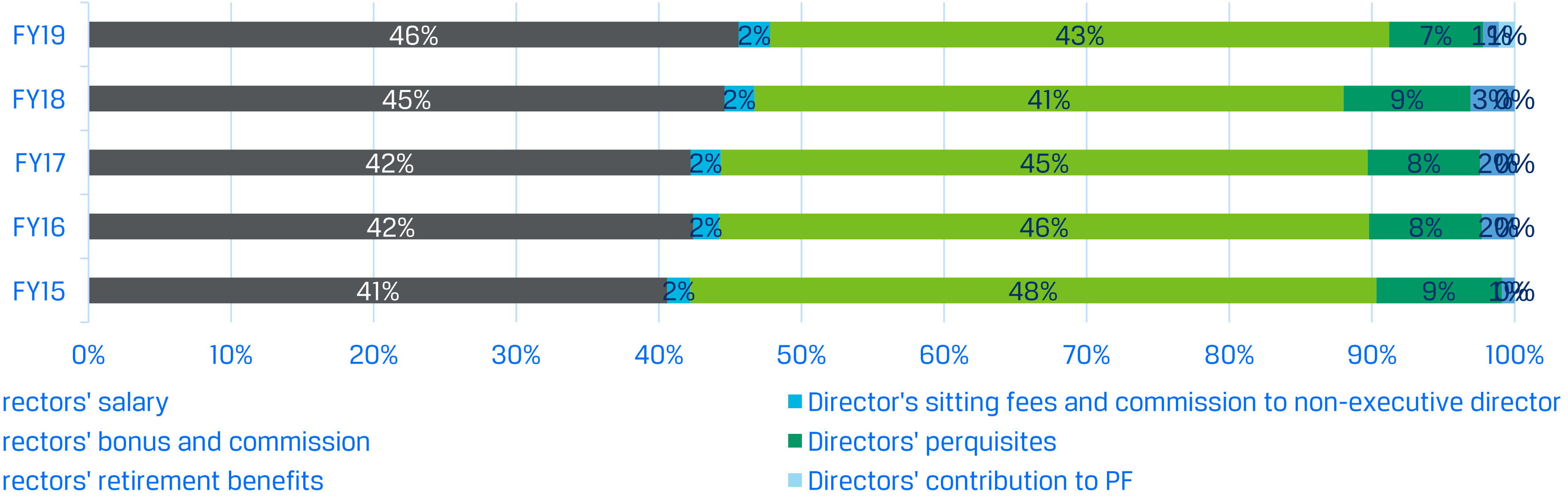
PERMISSIBLE REMUNERATION PAYABLE UNDER COMPANIES ACT 2013 – SCHEDULE V

- **When the company has inadequate profits/no profits:** In case a company has inadequate profits/no profits in any financial year, no amount shall be payable by way of remuneration except if these provisions are followed.

Where the effective capital is:	Limits of yearly remuneration
Negative or less than 5 Crores	60 Lakhs
5 crores and above but less than 100 Crores	84 Lakhs
100 Crores and above but less than 250 Crores	120 Lakhs
250 Crores and above	120 Lakhs plus 0.01% of the effective capital in excess of 250 Crores

DIRECTORS REMUNERATION ANALYSIS OF BSE 200 COMPANIES

Salary as a percentage of Total Directors' Remuneration has increased by 500bps over the past five years



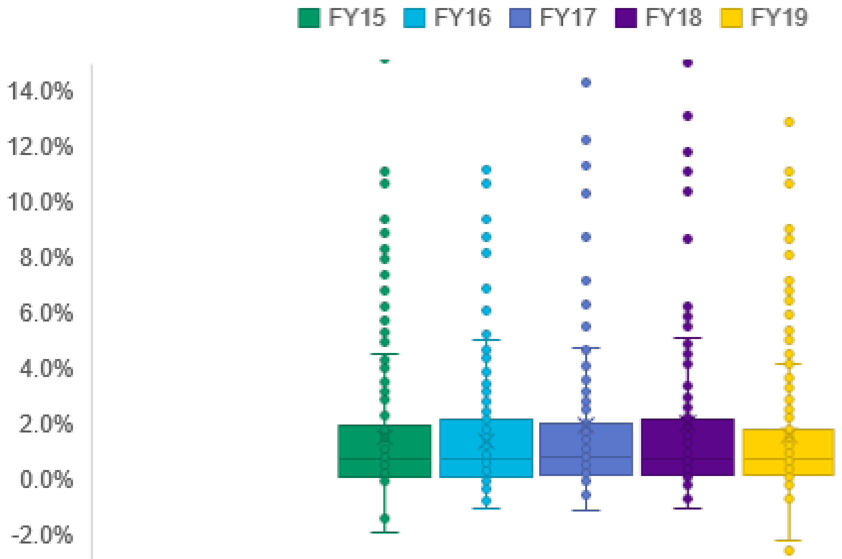
Source: Prowess database

^Net Profit before taxes and extraordinary items; Net profit as per section 198 not available in prowess database

CFA Society India

DIRECTORS REMUNERATION ANALYSIS OF BSE 200 COMPANIES

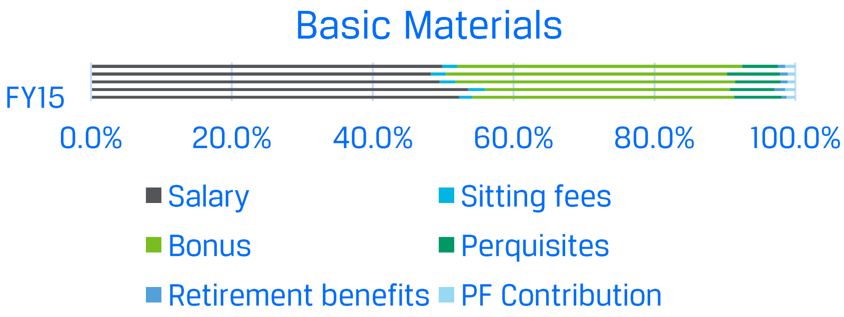
Most of the Companies pay Total Directors Remuneration as a Percentage of PBT^ in the quartile range of 0%-2%

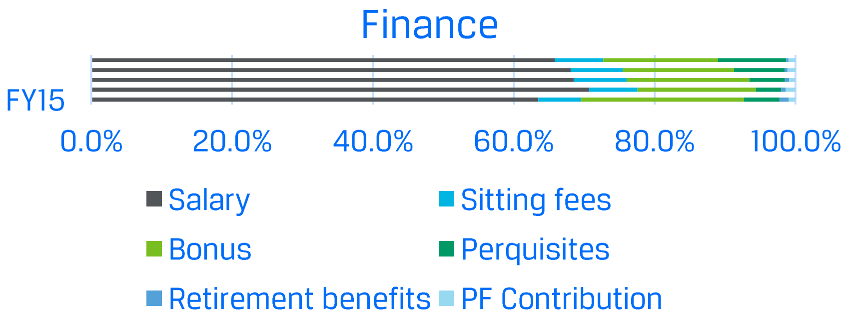


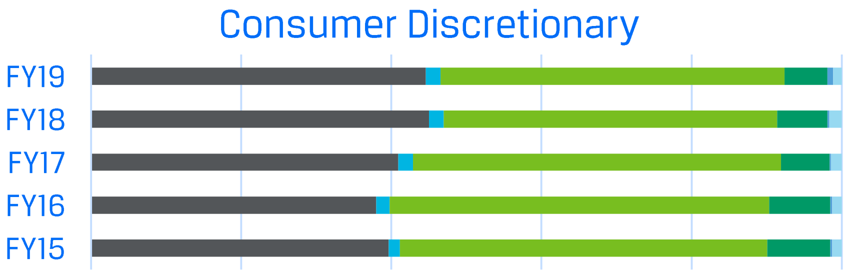
Source: Prowess database

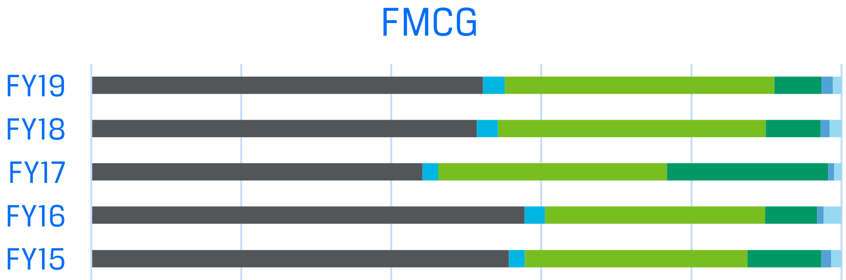
^Net Profit before taxes and extraordinary items; Net profit as per section 198 not available in prowess database

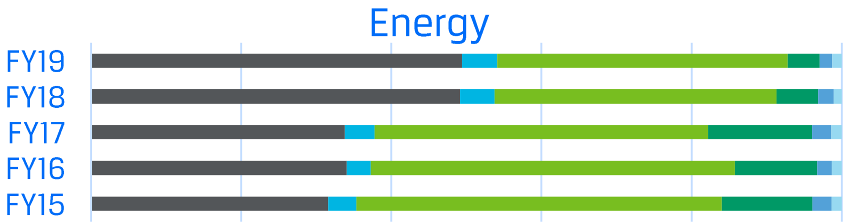
BSE Sector Indexes: Salary as a percentage of Directors' Remuneration has increased over the past five years across most of the sectors (1/2)

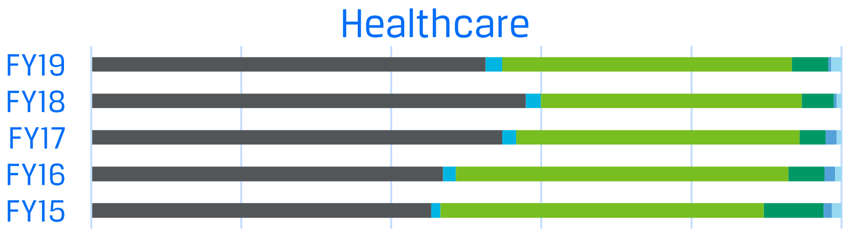




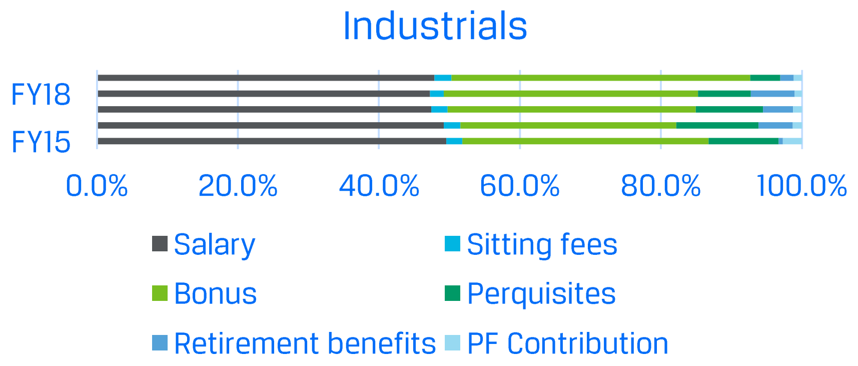


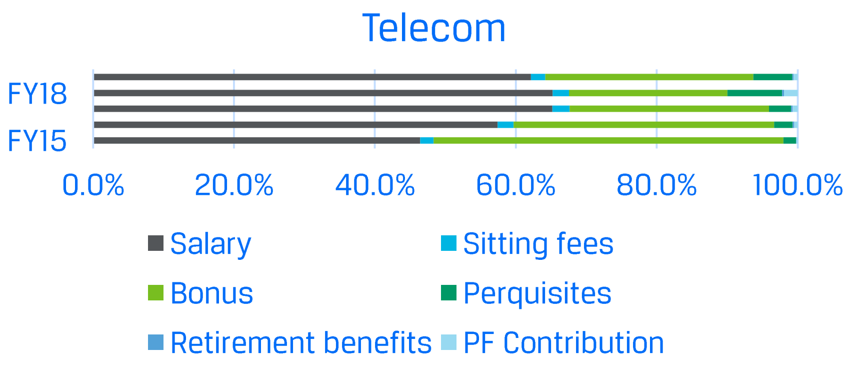


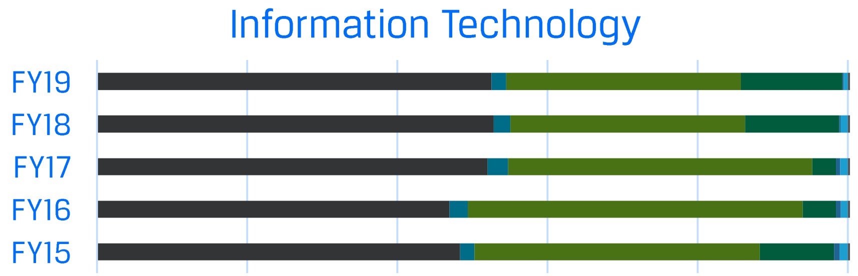


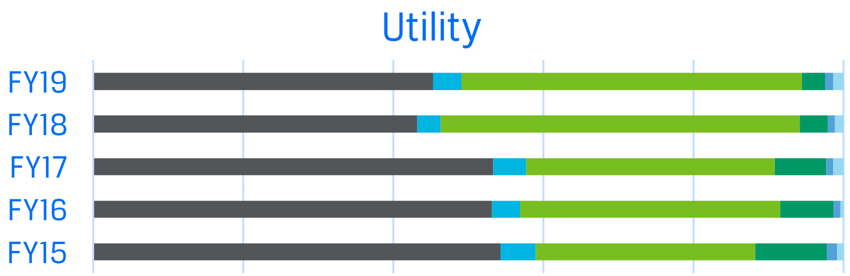


BSE Sector Indexes: Salary as a percentage of Directors' Remuneration has increased over the past five years across most of the sectors (2/2)









Additional Observations

- Finance and Telecom sectors have Salary as a percentage of Directors' Remuneration at 60%+ for the past three years (FY17-FY19)
- Unlike most of other sector indexes, Utility has seen Salary as a percentage of Directors' Remuneration decrease over the past five years (FY15-FY19)

CFA Society India

OBSERVATIONS FROM BSE 200 COMPANIES

- Since India has well defined laws, there is no legal issues with respect to KMP Remuneration
- However there have been specific instances and softer aspects, may be due to loopholes and less strict approach adopted by Remuneration Committee
- **Broadly the cases are as follows :**
  - Excess Remuneration paid after due approval , which have been protested by some minority shareholders
  - Salaries were capped due to investor pressure and not due to pro-active approach of Board/Committee
  - Companies where promoters take the remuneration within the limit; but take home every single rupee of the maximum remuneration allowed by the law:
  - High remuneration to promoter family members whose salary may seem very high when compared to the value-added by them
  - Companies where promoters extract maximum possible salary from all entities
  - Some loopholes used in definition of salary for section 198
  - Not mentioning Salary of key Employees as per Rule 5(2) and 5(3)
  - Paying money through subsidiaries
  - Some don't even mention the Remuneration limit as per Section 198, so investor cant readily calculate if limit has been breached

CFA Society India

CASE STUDIES

- Salary capped due to investor pressure
  - In 2018, The minority shareholders of leading tyre maker had driven chairman and vice-chairman and managing director to cap their compensation at 7.5 per cent of profit before tax effective FY19 - which increased in spite of a fall in the company's profitability.
  - More recently this happened in a Jewellery Company and Cement Company
- Companies where promoters take the remuneration within the limit; but take home every single rupee of the maximum remuneration allowed by the law
  - There have been instances with many companies calculate the profits at year end and then back calculate the maximum permissible amount and pay the KMP the maximum amount by balancing the commission amount. The salary matches the maximum permissible limit to last decimal
  - This amount often remains unpaid at year end, because this is mostly an after thought and can be verified from Related Party Transaction Schedule
  - Specific cases have been observed in Battery company, a sanitaryware co, and a Chemical Company

CASE STUDIES

- **High remuneration to promoter family members whose salary may seem very high when compared to the value-added by them**
  - Here it is evident that management is getting a compensation despite lack of work experience or participation or professional qualifications
  - In case of Auto Component Co, 82 year old Lady Director (mother of promoter) whose name doesn't even appear on the website in the management team received salary equal to MD
  - In a Jewelry Co – two daughters of Promoter were getting same salary as MD, despite less experience compared to MD

- **Companies where salaries increased despite no increase in profits**
  - In a Tyre Co and Alcohol Company– management compensation increased consistently despite consistent dip in profitability

CASE STUDIES

- **Using Own definition of salary for section 198**
  - Some companies specifically mention that they don't include PF, Gratuity etc. in Salary
  - Some exclude Gratuity and Leave Encashment
  - There have been cases where Director Sitting Fees has not been included

- **Not mentioning Salary of key Employees as per Rule 5(2) and 5(3)**
  - This section is important because it allows comparing salary of KMP with Other Employees so that comparison can be made if salaries are spread across the team or cornered by KMP only
  - Companies don't give the data in Annual Report, they just mention will be made available to any shareholder on request

CASE STUDIES

- Paying money through subsidiaries
  - Some companies pay excess salaries through subsidiaries, thereby bypassing requirement of Special Resolution
  - This was specifically highlighted in an Agrochemical Company and a NBFC

- **Some don't even mention the Remuneration limit as per Section 198, leave aside giving reconciliation**
  - Layman shareholders cant be expected to know Section 198 Calculations and ascertain the upper limit.
  - This has increased ever since MCA allowed excess salary without taking Central Government approval

- **KMP remuneration breach reported by the company in the annual report (Positive Scenario)**

- For a Real Estate Co, in FY19, KMP remuneration breach was reported in the annual report

CONCLUSIONS

- Excessive executive remuneration, not linked with performance, is a growing problem in companies in India. Data show that even when the companies are not performing well and the share value is declining constantly, the remuneration of executives is still touching skies. However the bigger problem with respect to Indian companies is that there is a huge gap between the salary of top executives and the other employees
- The Institutional investors, being equally responsible, must pull up their socks and cast informed votes while passing resolutions. They must start utilizing the voting power vested in them by law efficiently. The role played by proxy advisory firms in this respect is also crucial .They effectively serve as a counter against ill practices including inappropriate remunerations
- The problem is not with high executive remuneration but remuneration not adequately linked to performance and to effectively curb this problem all the participants must perform their role effectively to serve as a check mechanism

DESIRABLE FOREIGN PRACTICE

- In the U.S., until the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (henceforward, Dodd-Frank Act 2010), shareholders had no say in the compensation of the executive and the non-executive directors determined by the boards based on their compensation committee decisions. Under the Dodd-Frank Act 2010 (effective 2011): •
- Companies are required to hold an advisory (non-binding) vote on compensation at least once every three years.
- At least once every six years, companies are required to ask shareholders to determine the frequency of future say-on-pay votes (with the options being every one, two, or three years, but not less frequently)

REFERENCES

1. Published Annual Reports from FY 2014 to FY 2020 for specified companies covered under study
2. Companies Act, 2013
3. SEBI Listing Obligations and Disclosures Requirements Regulations 2015
4. Uday Kotak Committee Report (Recommendations) on Corporate Governance
5. CFA Institute

Thank You