



# Corporate Governance and Directors Remuneration-Indian Context

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## Abstract

The paper succinctly outlines the amelioration of corporate governance and directors' remuneration in India. Governance is about how an organization is being administered and controlled while corporate governance is about a system, procedure or tool of harmonizing between administering and controlling corporate internal affairs and the exigencies of its external shareholders and stakeholders. An endeavour has been made in the paper to emphasize polemics about the necessity of disclosure of director's remuneration, shareholders' approval on directors' remuneration, approval of directors' remuneration by a committee, segregation of role of the Chairmen and Chief Executive Officers, etc. Thereupon, it touches on the headway made by India in boosting the corporate governance practices. The paper also appraises few thrusting germane and offers recommendations on how the future approaches for the progress of corporate governance in India with regard to directors' remuneration shall take fashion.

**Keywords:** Corporate governance; Directors' remuneration; Corporate performance; Board; Agency problem

## Introduction

Excessive directors' remuneration unentangled with performance sprouts problem in corporate sector in India. Even when a corporate not performing well and its share value declines constantly, directors' remuneration still touches skies. However, the big problem concerning Indian corporate is that there is a huge gap between the salary of top executives and other employees. Though supporters explain it to be a result of dearth of talent at top level but even then too much difference cannot be justified. Drastic differences in pay levels evidence some tricks in play in the corporate governance (or, CG). Moreover, public attention on CG acclimates due to high profile corporate failures. Although directors' remuneration as a mechanism of CG is viewed resolving agency problems, it has transformed itself into a CG problem. This paper provides a brief description of theoretical perspective of directors' remuneration. The relationship between executive remuneration and CG has also been highlighted. Furthermore, whether directors' remuneration is considered as a problematic mechanism or a solution has been discussed in details.

## Materials and Methods

### Literature review

This part occasions the conceptual and theoretical reviews of the subject matter. Various studies evidence the impact of board size on financial performance of firms. Glowing CG tool especially board independence supports positive association between financial performance and remuneration. Board size has major impact on CEO compensation indicating crucial part of the board size in the directors' remuneration [1]. Opined that shareholders have right to approve or disapprove directors' remuneration [2]. Examined the implication of ownership concentration on CEO compensation and firm performance with the help of regression analysis for the period from 2001 to 2005, and observed negative effect of ownership concentration on CEO compensation and financial performance [3]. This study bespeaks the manner where ownership structure can moderate the association between CEO compensation and performance. Further, Studied on the relationship between firm performance, CG and executive compensation in 13 companies listed in 2007-2009 on the Indonesian Stock Exchange, and found positive relationship

**Received date:** 11 April 2021; **Accepted date:** 24 April 2021; **Published date:** 29 April 2021

**Citation:** Das PK (2021). Corporate Governance and Directors Remuneration-Indian Context. SunText Rev Arts Social Sci 2(1): 118.

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between executive compensation and ROA [4]. Higher the company profit, higher the bonus. The study finds also that the mechanism of CG can strengthen the relationship between executive compensation and performance. Investigated the connection between directors' compensation, CG and financial performance of 150 companies listed on the Bursa Malaysia for 2008 to 2013 with the help of panel based regression model [5]. The findings show that company size variable indicates positive and invincibly expressive with ROA. Leverage variable stipulates negative but significant with financial performance (ROA). The results show positive and significant relationship between director compensation and company performance. Studied on the moderating role of CG on the compensation and performance in South Africa taking a sample of 407 non-financial companies quoted on the South African Stock Exchange for the period from 2003 to 2012. The result suggests synchronic association among board characteristics, executive compensation and firm performance [6]. CEO power and CG technique can moderate compensation and financial performance. Studied the cushion effect of CG and dividend policy on CEO compensation and financial performance of 287 Pakistan listed companies for the years from 2010 to 2014 [7]. The findings signify that family owners confederate CEO's compensation with working parameters, institutional owners with market efficiency and company magnitude, and foreign investors with market share. It also reveals that ideal board size reinforces pay-performance link. On the other hand, CEO dichotomy and dividend policy modify pay-performance link. Prescribed in their conflict of interest of distinct beings in executive remuneration procedure and agency problem [8-19]. Proclaimed close relationship between directors' remuneration and performance epitomized that firm financial performance is positively but not strongly correlated with CEO pay divulged unhealthy relationship between firm performance and CEO compensation for bilateral subornation of CEOs with directors. The study of explored coexisting reciprocation between compensation and financial performance with identical board characteristics also observed direct relationship between directors' remuneration and firm performance [20].

### **Objective of the study**

The objective of the study is to highlight the association between directors' remuneration and CG practice particularly in India.

### **Research question**

The research question raised in addressing the study objective is what impact does CG has on directors' remuneration in Indian context.

### **Research methodology**

The study is descriptive in nature and conducted by variety literatures in terms of CG and directors' remuneration. Descriptive research has been preferred for developing better profundity of knowledge. Thus, this study purely adopts secondary data collection strategy, and considers a variety of secondary sources accessed through the Internet and academic databases viz. literature reviews, empirical studies, website, books, journals, reports, etc. The work is designed for a cross-section of those for making the issue easily understandable and organized into several sections/parts. The inherent limitation of the study is that as the study is based on published data and information, and this secondary sources may be lacking in authenticity, the result inferred there from may not be completely reliable.

### **Discussions and Results**

#### **Association between corporate governance and directors' remuneration**

Association between CG and directors' remuneration can be explained by the agency theory. The theory concerns the relationship between management and shareholders in which management works as agent for shareholders' best interest. Although individual members work in their narcissism, well-being of every individual depends on the well-being of other members. Management and shareholders have different outlook for risk avoidance. Management does its best to improve the financial performance of company. Shareholders mind to influence executives by designing incentives to align their interest and directors. Statutory requirements mandate all listed companies to publish directors' remuneration report with their annual financial statement. Stock exchange regulations also require full remuneration disclosures and policies for executives. This minimizes risk of excessive remuneration and enhances transparency. Trust and fairness must exist in the matter of directors' remuneration.

#### **Agency theory and executive remuneration**

Thus, principal-agent theory behaves as cornerstone of executive remuneration and governance practices. Executives obtain company loan with low interest and sometimes even interest-free. Opined if separation of ownership and control eventuates, agency problems subsist [21]. Still managers use company's assets to enhance their lifestyles and satisfy their claims without regard for shareholders.

#### **Agency problem**

Directors perform the task of managing daily affairs. Their decisions often influence their personal interest instead of

increasing shareholders' value. Directors cannot be expected to perform with same diligence in managing other people's investment as they manage their own money. Managers and shareholders have conflicting interest. Agency cost arising there from is must in any organization where the control is in the hands of agents. Properly structured remuneration scheme reduces agency cost by aligning executive's interest with that of shareholders. But due to improper regulations, executives milk their discretion and maximize own remuneration against the overall interest of company. Thus instead of minimizing agency cost, it becomes a tool for further exploitation.

### Executive pay as positive perspective

High executive pay often tempts splendours with high performance and acts as positive perspective in company. Incentives motivate, reward and discipline executives to take risky projects and achieve increased return in the company. Explained that optimal cognition motivate narcissistic manager to adopt investment policies that increase shareholders' wealth with executives' remuneration [22]. According to return on assets, earnings per share, return on capital employed, shareholders' return and directors' performance measure performance [23]. However, negative relationship develops where executives behave fraudulently to materialize high remuneration [24].

### Existing regime in India

To ensure equitable remuneration to executives, the law intervenes to balance the conflicting interests. Executives' remuneration is governed by the following:

- Companies Act, 2013
- Schedule V of Companies Act, 2013
- Clause 49 of Listing Agreement, SEBI

Companies (Appointment and Remuneration of Managerial Personnel) Rules, 20

### Key highlights

- Section 197 of the Companies Act, 2013 states maximum ceiling of 11% of net profit to its managing director, whole time director and manager. However, excess of the prescribed ceiling must get shareholders' approval in general meeting. The Act also stipulates ceiling on individual salary to be 5% of net profits.
- Schedule V of the Companies Act, 2013 details about disbursement by company in case of no profits or inadequate profits. Any excess needs Central government's approval.
- The law also imposes restrictions in other forms of remuneration e.g. Central Government has restricted a sum of Rs.1 lakh per meeting on the sitting fees of directors.

- The Company is not empowered to waive recovery of refund where sanction of remuneration exceeds the prescribed limit without the Central Government's permission.
- The law provides for disclosure of remuneration in board report.

The Central Government mandates the following disclosures in board report:

- Ratio of remuneration of director to that of median employee.
- Percentage of increase in CEO remuneration and that of each director.
- Percentage increase in remuneration of employees.
- Relation between percentage increase in directors' remuneration and company's performance.
- Fluctuation in market value of shares for listed companies and for unlisted company's fluctuation in the net worth of a company.
- Reason for increase in managerial remuneration.
- Disclosure of employees' name whose remuneration is more than Rs.60 lakh p.a. and also disclosure of the fact if one becomes a relative of director or any manager.
- Secretarial audit report should mention whether the remuneration of executive directors adheres to the Companies Act.

### Shareholders "Say on Pay"

Shareholders' involvement in determining remuneration is welcome. Certain strict disclosure practices enable them taking informed decision. In India, excess of remuneration over the ceiling as prescribed in Section 197 of the Companies Act, 2013 needs shareholders' approval. Still, this process is merely a formality with no real benefits for the reason that most of the companies in India are concentrated ownership. Remuneration is easily approved since the interested party belongs to majority shareholders. Minority shareholders are least interested. They know that their voice does not count. In companies where promoters acting as CEO also vote on their remuneration packages and they being the majority shareholders, there remains little chance to disregard the approval of their remuneration. Thus, the entire process of "say on pay" in India becomes ineffectual. Even though the legislation permits the shareholders for vote, in practice it has just turned out to be another formality of compliance. However, shareholders' vote on pay would be effective subject to the proposal suggested by SEBI. The Companies Act and CG have taken different approaches to regulating directors' remuneration. CG takes more proactive approach stating that premium listed companies should have transparent procedure for developing policy on remuneration. CG provides that company should form a remuneration committee containing only independent non-executive directors to control excessive executive pay.

Shareholders should be well-equipped about company's remuneration policy. "Say on pay" empowers shareholders' voice and encourages remuneration committee to challenge directors' remuneration.

### Role of Remuneration Committee

Remuneration committee devises executives' remuneration according to their performance. The committee must be independent and free from any prejudice. According to Section 178 of the Companies Act, 2013, remuneration committee must include three or more non-executive directors half of whom must be independent. These independent members protect shareholders' interest and keep a check on board activities so that it is not detrimental to the overall interest of company. However, committees have not proved much effective. Firstly, committee being of both executive and non-executive directors, chances of biasness still remain. Secondly, non-executive directors suffer from agency problem. Thirdly, independence of these directors is questionable. Often, these directors are friends or deep relatives of executives. They stay in the company just for the sake of formality. Fourthly, to legitimize high remuneration, they tend to keep in terms with the executives allowing big remuneration. Fifthly, most of the non-executive independent directors being executive directors of other companies at present or in the past have compassion towards other executives and support such remuneration. Statutory provision proves insignificant in so far it just adds to compliance cost with no real benefit.

### Impact of dual role of CEO appointed as Chairperson

Dual role of CEO appointed also as Chairperson in certain companies is a debatable issue. CEO is responsible to board headed by Chairman. Board members are responsible to protect investors' interest. They also estimate the performance of other executives including CEO. Few opine dual role ensures unified command and minimizes conflict of interest. However, the stronger view is that this invites poor CG and undermines the separation of powers. It also makes the independence of the board questionable. Companies having separate CEO and Chairperson, level of remuneration is comparatively low as compared to other companies where there is no such separation. Section 203 of the Companies Act, 2013 states that one guy cannot hold both the position of CEO as well as Chairperson barring a few exceptions stated in the Act.

### Potential reforms

Shareholders being owner of a company, the duty of disclosure rests on them. Top level pay might emerge grave impact for general. The concept of supply and demand though important, but it only sets the boundaries wherein the service value bears little relation to real value. Induction of workers into boardroom arrests

excessive directors' remuneration and draws extra benefit for the efficiency of firm. More transparency goes towards tempering public unrest and injustice of large salary. Such contribution proves valuable in solving the agency issue at the core of CG.

### Criticisms

- **Apocalypse of negative signs:** Executives' remuneration increases focus on personal interest and ignores shareholders' interest resulting turmoil on the company's viability and general economy. Emphasized that performance-based remuneration exacerbates agency problem where alignment is absent between shareholders' interests and executives [25]. They also enunciated that executive remuneration scheme as a solution to align agent-principal's interest is "an illusion". Executive remuneration is a potential instrument to address agency problem and also a part of agency problem itself.
- **Weak accounting-based incentives:** Avowed that accounting-based incentives create weaknesses if accounting profits are taken as performance indicator [22]. Executives can enrich research and development to make company looking lucrative. Executives alter financial statements for exhibiting high profits and getting high executive remuneration. Such manipulation is vital in 'true and fair view' of company's financial statement.
- **Weak stock options and excessive risks:** Stock options face difficulties on the alignment of managerial incentives with shareholders' goals. CEO increases dividends to increase stock price and follows risk business strategy for high stock options award. Manipulation increases profits and makes stock price favorable leading to bankruptcy. Shareholders pressurize companies to generate high returns untenable with management's remuneration.
- **Lack of connection between performance and remuneration:** All companies irrespective of their financial condition abuse stock price increase. Executives of poorly run companies receive high remuneration even when they do not deserve it. Conversely, during economic difficulties, executives are awarded.
- **Executive pay as executives' greed:** Executives' pay coheres executives to strengthen shareholders' wealth. However, poor CG impoverishes managerial entrenchment and moral hazard. Huge executive pay drives CG to erosion with the message that board spends shareholders' money without proper care.
- **Golden goodbyes' consequence:** Executives receive "Gratuitous Goodbye Payments" after retirement. Executive pay as CG mechanism is eroded due to non-compliance with the SEC disclosures where shareholders and investors get detailed information about executives' pay arrangement for transparent company strategies and procedures.



## Issues in India

Excessive executive remuneration even when corporations are in a state of collapse is one of the major issues over the world. In India, the situation is not alarming but this needs to be taken prudently. Recent corporate frauds like Satyam fraud, Kingfisher's fraud, etc. have unbosomed the dark side of Indian CG practices. Behind almost all these frauds, executives' huge salaries at the expense of stakeholders are observed. They use tricks to defraud investors and creditors. Various remuneration schemes of directors in Indian companies focus basically three key issues viz i) Absence of close association between remuneration and performance. ii) Glaring difference in the remuneration level of executives and median employees. iii) Paying much more to CEOs in comparison to non-CEOs.

## Influence of ownership structure

Agency problems are common torment in the countries having separation of control and ownership. In India, maximum companies have concentrated ownership. Majority shareholders have a say in the management; but this does not mitigate problem. In concentrated ownership, regulations demand more stringent to protect minority shareholders' interest not just against the executives but also against majority shareholders. Minority shareholders whilst having voting power are customarily passive as they know that their individual vote does not matter much. Dominant shareholders easily take mass decisions even at the expense of minority shareholders. One such decision is high executive remuneration not based on performance. Dominant shareholders holding executive positions earn much more from their salary than what they earn from dividends. In many countries, there is no clause for mandatory remuneration committee. In India recently, Section 178 of the Companies Act, 2013 has mandated this provision for all the listed companies.

## Performance and remuneration

Appropriate executive remuneration serves as an incentive to attract talented executives for strengthening shareholders' value. Contrarily, perception of remuneration for performance appears righteous but realistically it is not so. Board and the remuneration committee should shed light on the determinants to measure performance. There is no straight jacket formula for evaluating performance-based remuneration. Evaluation criteria must meet explicit methodology. Design favoured must appropriately align executives' interest with that of shareholders. Indian Companies Act, 2013 has strived to associate remuneration with performance by arranging maximum ceiling formulated on net worth and anything beyond this requires shareholders' approval; also apropos inadequate profits no pay more than the amount prescribed in Schedule V shall be conferred without the Central Government's

approval. However, provisions are not truly draconian. Shareholders' vote to enhance remuneration is easy in a family owned company. Executives' remuneration keeps growing even when the company's performance is unhealthy. There is gap left either in the implementation of law or in law itself. However the problem is not merely legally-based but also reluctant etiquette of companies. Strengthening ggip is not simply the responsibility of administration but the corporation itself instances initiative to further this intention. Healthy governance practices always keep company healthy.

## Conclusion

Excessive directors' remuneration non associated with performance is a pressing concern in Indian corporate. Sometimes even though the companies malfunction and share value declines constantly, directors' remuneration still touches skies. However, the big problem is that there is a huge gap between the salary of top executives and other employees. Though proponents explain it following the outcome of mediocrity at lofty but even then much asymmetry is untenable. Yawning gulf in income ladder evidences few tricks in play in the governance. Problem is not with how remuneration is decided but who decides remuneration. Indian regime over this issue fairly endeavours to associate executive remuneration with performance and has provided detailed provision to determine remuneration but all these have been hopeless majorly because of the absence of actual independence in determination of remuneration. Shareholders say on pay and the remuneration committee is just another compliance for the companies with no real outcomes.

## Recommendations

Law does have responsibility to enhance sound governance practices. Institutional investors must utilize their voting power efficiently. Consultancy companies' participation hereof is also crucial. They effectively serve as a counter against ill practices besides grotesque remuneration. Companies must heed that stewardship is always win-win. Awarding mitzvah leads to growth of company climatically as it buoys to further the mission of company. Company would grow with the growth of its employees. Thus the problem is not with high executive remuneration but remuneration not adequately linked to performance and to cosily tame this problem all the participants must discharge their posture felicitously. Calls for immediate legislations and reforms are dire need to find out possible solution for arresting this devastating situation.

## Comment

Potential crisis of executive remuneration cannot be well-groomed to employability as CG mechanism. Directors are never happy with



their remuneration; they want more. Proponents assert parroting executives deserve such rewards. Proper management and CG code can benefit both principal and agent without eroding any principal-agent concept and company's financial status. Edacity is in human's DNA acting without reckoning its consequences. Most financial scandals make employees workless, pensions off and ensuingly, someday employees shed tears. Initially, directors' remuneration eyes spring but a sudden ebbs and the aftereffect follows methodically.

### Research implication of the study

Company management produces big swing in directors' remuneration because of convergence of various factors necessitating re-examination of the structure and make-up of remuneration. Convergence aspects are mainstream towards transparency, accountability and cohesion between remuneration and performance, and increasing accountability of the board of directors for CG and sustainable value creation.

### Acknowledgement

The paper is devoted to ALMIGHTY GOD who bestows HIS blessings in all walks of my life.

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