Non-executive-Independent Directors, Pay-performance Sensitivity Analysis of Bombay Stock Exchange (BSE)-260 Firms

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Abstract

There are plethoras of studies on CEO's compensation unlike non-executive independent director compensation; this study uses data of independent director compensation to examine the relation between independent director compensation and firm performance by using perspective from agency and institution theory.

The design of the study is for two years 2005 and 2010, from BSE-500 companies listed in India because these two years are crucial for testing the corporate governance policy related to independent directors compensation.

The findings provide opportunistic behavior on part of Independent director in relation to their compensation and shareholders wealth as well weak institution norms with respect to compensation structure.

Key words: *Executive Compensation, Corporate governance, Independent director, Indian firm, Firm performance.*

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I. Introduction

The compensation of top executives is receiving huge consideration both in the press and the published journals. This study on managerial incentives and compensation has been carried on for more than seven decades and the extant literature comprises of more than 300 studies (Barkema & Gomez-Mejia, 1998).

The researcher, scholars, practioners have studied this area of executive compensation for years, as well recent surge in corporate scandal have brought the public authorities and general public interest into the area of executive compensation due to some exorbitantly high compensation of some CEOs, which received hostile media glare .

In spite of surge in the literature of executive compensation there is no clear cut relationship emerging out from the literature on the pay-performance relationship.

Further emerging studies in executive compensation either fails to validate the earlier studies, due to new relationship emerging in the current studies. So, this has led to fundamental confusion in pay-performance literature.

In a nutshell, there is ambivalence as to the exact nature of executive compensation and firm performance. Hence, varieties of studies on compensation and performance doesn't integrate into one uniform theory (Devers, Cannella JR, Reilly & Yoder, 2007).

II. Objectives

Early studies in this area focused on an effort to understand the true nature of the pay-performance link by considering the unexplored factors which are sufficient enough to cause the variation in the results. A variation in results has caused and thereby provides recommendations for future research aimed at developing a more integrated research agenda (Sousa & Voss, 2002).

This study using extant literature so as to remove fundamental confusion about the pay-performance link

.This study seeks to investigate issues that have received little or no attention in the past and contribute to the literature by exploring nature of variations in Independent director compensation and firm performance.

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III. Aim of the Study:

The study uses the two varying data for the year 2005 and 2010(before-after design)to examine the relation between independent director compensation and firm performance.

IV. Rational of Study:

This study is relevant, with the view…

"that academics have shown less interest in understanding how non-executive board members are compensated and what effect their compensation has on firm performance "(Sarkar and Sarkar , 2012).

V. Pay-performance: Theory, Literature and Argument

Agency theorist view in corporate finance, the firm is usually considered as the result of "*a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations*" (Jensen and Meckling, 1976, p.311). However, the contractual relations can be only explicit or both explicit and implicit. We will consider the firm as a nexus of explicit and implicit contracts. (Zingales, 2000, p.1633).

In truth the research carried from agency theory perspective has not reached the optimal contracting theory, prior research on pay-performance shows weak relation and low sensitivity between pay-performance of CEO/Directors, for instance, US result from Lippert and More (1994), Yermack (1995), Jensen and Murphy (1990) and Gibbons and Murphy (1990).For UK studies see (Buck et al, 2003,Main et al., 1996,)and Indian studies see- Ghosh (2003), Parthasarathy, Menon and Bhattacharjee (2006)

Enter in *institutional theory* adds socially constructed limits like norms and rules - as obliged and justified by society - that affect economic choices (Oliver, 1991 & 1997a). DiMaggio and Powell (1983) provide an explanation for processes that tend to make organisations more similar but with varying levels of firm efficiency. They settle on *isomorphism* which is defined as "a constraining process that forces one unit in a population to resemble other units that face die same set of environmental conditions"(Hawley, 1968). Institutionalised patterns bring about firm heterogeneity as well, although some institutionalists (like DiMaggio, Scott, Powell, Meyer) argue that conformity with external socially accepted norms leads to homogeneity and thus greater chances of firm survival. The institutionalist argument therefore considers that high performing firms are those that best conform to social pressures, and the more homogenous a firm becomes, the better its performance. Hence, the introduction of clause-49(equivalent to Sarbanes –Oxley act of U.S.A) of stock exchange listing agreement of stock exchange, enhances the sensitivity of independent director compensation to firm performance.

This study draws from both, the agency theory and institution theory, an exploratory analysis from large longitudinal data set of same BSE-260 firms for the year 2005 and 2010, full sample represent 520 firms, to test both agency theory and institutional theory (clause -49) which was introduced in the year 2004, regarding the predictor and consequences of independent director compensation level sensitivity of Indian BSE-260 public companies.

Hypothesis-1: The introduction of Clause-49,* (equivalent to Sarbanes –Oxley act of U.S.A) *represent optimal pay-performance level of independent director compensation.

VI. Methodology of the study:

The method used is multivariate regression for cross-section of the year 2005 and 2010, which contains 58 industry control ,fixed effect and random effect model was used for the full sample that year 2005 and year 2010.

VI.1Sample and Data collection

The sample includes 520 firms observations-260 firms (see ANNEXURE-I) from Bombay stock exchange-BSE-500 for the year 2005 and *same* 260 firms for the year 2010. The firms were selected at random. If the firm had observations in both sample years, and if both sample –year observations met the data requirements, then both years are included in the sample. This process was continued until 260 observations from each year selected.

VI.2.) Relevance of the Year- Two factors has played a major role in India, in the last 10 years or so, corporate governance and the institution of independent directors have evolved. First, introduction of Clause 49(considered equivalent to Sarbanes –Oxley act of USA) by security exchange board of India (SEBI) in year 2004 and the Satyam fraud in year 2009 are considered as important in improvements in corporate governance and the role of independent directors.

a) Justification for the Year 2005 data: Clause 49 was introduced by security exchange board of India (SEBI) in year 2004 so the data of year 2005 to see the impact of clause 49 (of Indian stock exchange listing agreement for Indian companies) on Independent director's compensations and shareholders wealth.

b) **Justification for the Year 2010 data:** The Satyam Company scam in the year 2009 had a major impact. Dozens of independent directors resigned from a number of companies as responsibilities and risks of being a board member became clear. So, the author considered /assumed that in the year 2010, only those who are sure of their effectiveness continued as independent director, other important thing that happened in the year 2010 was their compensation went up after this event.

So, in conclusion, after the Satyam scam of the year 2009, Clause 49 resulted in the induction of more independent directors and improvements in board processes. Boards meet more often as required by the regulations; it is assumed directors are speaking up in board meetings to ask substantive questions, voice concerns and offer advice rather than just to pop in a cashew as in the past that is before the Satyam scam of 2009.

VI.3 Variable definition:

a) Net sales is the accounting figure from the profit and loss statement (in rupees)of the company for the year in which compensation is awarded.

b) EPS, ROCE, RONW is accounting ratio figure calculated from the annual statement of companies for the year in which compensation is awarded.

   Earning per share (EPS) is calculated defined as Profit After Tax divided by Total number of equity shares issued for the fiscal year, 2005,2010 year in which compensation is awarded.

   Return on net worth (RONW) is defined as net profit divided by net Worth.

   Return on capital employed (ROCE) is best defined as operating profit divided by capital employed (net worth plus debt)

c) Total compensation (Salary, Board Sitting fees and commission)is the compensation amount in Rupees reported in the balance sheet of the particular companies for the year in which the compensation was awarded.

Table -1 : Descriptive statistics of the compensation and firm performance of the year 2005 and 2010 used for regression analysis

		2005 Sub sample			2010 Sub sample	
Variable	**Mean**	**Median**	**Standard deviation**	**Mean**	**Median**	**Standard Dev.**
Compensation Variables						
Board sitting fees (Rs.)	87438	51000	108578.9	116535	84000	122098.7
Commission (Rs.)	272436.9	0000	735978.2	405446	0000	918046.4
Salary (Rs.)	10549.30	0000	220636.7	9931.324	000	248979
Total compensation(Rs.)	386444.3	120000	840430.0	546973	200000	977836
Performance Variables						
Net Sales.Rs.(In crores)	4814.416	1201.865	21134.45	4716.599	1339.280	19670.26
EPS	18.32	8.05	53.01	20.08	8.00	38.00
ROCE	17.20	15.00	16.16	17.25	14.00	16.36
RONW	17.91	17.00	16.67	17.40	17.00	17.32

Note-1million=Indian Rs.10 lakhs;

1 US $= 43.62 Indian rupees (Rs.) as on 30th March'2005:

1 US $= 45.03 Indian rupees (Rs.) as on 30th March'2010:

Indian Rs.10 Lakhs =Rs. 1million.:Indian Rs.1 crore=Rs.10 millions

Data Source: Authors compilation from the annual/balance sheet of 260 companies from BSE-500 (see ANNEXURE-I).

VII.MODEL SPECIFICATION

The first test will use the accounting measure of firm performance, ROCE, as the dependent variable. The specific regression takes the form :

Independent Director Compensation = function of (sensitivity of Company Performance)

Where:

Company performance=ROCE, RONW and EPS= the return on assets for the year 2005, year 2010 ,

Structure of Directors Compensation Includes= (Salary, Board Sitting fees and commission)

Regression Result:

Jensen, 1990; Murphy,1985 emphasized the under mentioned model to study Pay-performance relationship for CEO's who are the full time employees of the company, unlike the Independent director, whose role is to monitor the board of directors. The same approach with little modification is used here, the purpose is to diagnose the possible performance variable effecting the pay of the Independent directors , rather than to measure the rate of change of the performance with respect to pay.

Table-II: Regressions result of Compensation of Independent Director on Earning Per share(EPS), and Return on networth (RONW), and Return on capital employed (ROCE) and NET SALES, with INDUSTRY CONTROL t -statistics tests indicated in parentheses beneath the coefficients.

Total compensation (commission + Sitting fees + In some case salary) for period

Independent Variable	YEAR 2005 Total compensation 1 OLS	YEAR 2010 Total compensation 2 OLS	YEAR 2005+ 2010 Fixed effect Total compensation 3	YEAR 2005+ 2010 Random effect Total compensation 4
Intercept	162241.4*** (5.268081)	372040.4*** (8.159433)	52732*** (1.2829)	54309.65*** (1.223835)
Performance Variables				
EPS	-20.08549 (-0.053297)	-323.1818 (-0.425961)	-166.013 (-0.6813)	-185.1586 (-0.77)
RONW	3753.847* (1.798191)	1628.913 (0.554585)	2921.12 (1.5090)	2971.84 (1.6200)
ROCE	-123.3928 (-0.057277)	9627.322*** (3.106247)	5016.27*** (2.6788)	5294.62*** (2.9815)
NET SALES	0.976666 (1.181299)	4.774055*** (3.385221)	4.4583*** (8.9432)	4.238184***
Year Dummy 2010	-	-	384205.6*** (10.1926)	386563*** (10.680)
$AdjR^2$	0.005815	0.035706	0.10	0.0591
F	2.683053***	12.20094***	8.039***	45.9615***
No. Of firm/companies	260 companies	260 companies	520	520
No. Of Observation	1376	2860	4230	4230

*** Indicates statistical significance at the .01 level, two-tailed **Indicates statistical significance at the .05 level, two-tailed * Indicates statistical significance at the .10 level, two-tailed

Regression Analysis: From the above table, the independent director compensation is sensitivity to RONW, as it is statistically significant in the year 2005, whereas for the year 2010, the sensitivity is for year ROCE and NET sales, so there is marked change in the year 2010, which can be seen from the regression model of full sample.

Whereas the regression parameter although not statistically significant for EPS variable, the director is negative.

Further, there is marked difference in the year 2010 where ROCE and NET sales have statistically significant effect on the compensation which is further substantiated by model run on full sample.

VIII. Discussion and Conclusions

First, the result indicates opportunistic earning management on the part of the Independent directors by providing negative direction of returns for shareholders that is EPS.

Second, the institutional appears ineffective as the result shows the compensation structure does not motivate the independent directors.

Furher, this study is consistent with the result from other studies on executive compensation which shows low but positive pay-performance relationship mainly for instance, US result from Lippert and More (1994), Yermack (1995), Jensen and Murphy (1990) and Gibbons and Murphy (1990).For UK studies see (Buck et al, 2003, 1999,Main et al., 1996,)and Indian studies see (Ghosh (2003), Parthasarathy, Menon and Bhattacharjee (2006), apart from the negative direction of the variable EPS, although not statistically significant, of Independent director compensation , but it coincides with study on Dutch firms by Duffheus and Kabir (2008) which shows negative relation.

The importance of EPS is shown in several corporate finance textbooks reveals shareholders wealth as goal of public companies (Brealey and Myers (2003), Brigham and Ehrhardt (2002), Moyer, McGuigan and Kretlow (2003)).

So, there is no ambiguity in corporate finance theory, teaching and the typically recommended practice are all built on the premise that the primary goal of a corporation should be shareholder wealth value maximization that is Earning per share (EPS). Extant theoretical and empirical research in financial economics also generally accept shareholder wealth maximization as the normative and ideal goal on which all business decisions should be based. This paradigm assumes that there are no externalities and all the participants engaged in transactions with the firm are voluntary players competing in free, fair and competitive markets.

There is a deviation in the result with respect to EPS, shareholder's wealth, there is non-linear relation between pay and performance of the firm; and pay-performance sensitivity is negative for the EPS in comparison to the Net sale, RONW and ROCE. So, from the institutional and agency theory perspective, possible explanation, in the Indian context, there is *institutional voids*, voids refer to the lack of institutional norms and regulations (Khanna & Palepu, 2000). Other possible explanation can be lack of institutional and agency problem which discourages the hiring of capable professional agent- independent directors in positions and setting proper compensation structure of independent director to effect shareholders wealth and firm performance.

IX. Policy Implication

First, from agency/institution theory perspective, by law, Clause-49, India's public listed firms are under no compulsion to set up compensation or remuneration committees. This leads us to another question whether pay-performance governance mechanism in India is adequately empowered to set up well -structured executive short term and long term compensation package which supports the firm performance? Very low inclusion of variable pay component lessens the riskiness of the compensation structure of independent director to shareholders wealth and firm performance in India.

Second, other issue is how much sensitivity and what structure of compensation is optimal? Agency theory literature and institutional theory is silent on proper compensation structure and appropriate sensitivity to linearly align compensation structure to shareholder wealth and firm performance.

Lastly, Most of Indian companies, which are owned by founding members/dominant shareholder (promoters) ,when designing the compensation contract because of information problems and flawed regulatory structures (Sun, Zhao and Yang, 2010).Asian family business report 2011 by Credit Suisse Emerging Markets Research Institute says that in India, 67% of listed firms are family managed. So setting compensation package of the top executives, some of them are - lack of efficient empowered remuneration committee, regulatory mechanism, governance structure, fair and transparent structure of independent director compensation aligned with the firm performance.

So, majority of India firms are unique in the way that the owners are the manager ,Ghosh,2006, Also, Indian corporate firm, are quite different from the Western countries model, it has hybrid corporate governance system, a mix of Anglo- Saxon model ,organized on joint-stock companies , with single-tier board and high insider ownership of promoters/dominant share holder based on European continental model, appear ineffective with respect to Earning per share (EPS) in relation to independent director compensation, which raises concerns over the current norms of clause-49 and companies acy-1956 , and supports the point that one of the major issues in the corporate governance system of India , dominant shareholder/promoters/ family managed verses minority shareholder interest can be balanced by having a institution norm for compensation structure of independent directors aligned with the minority shareholder interest that is EPS.

X. Limitation of the Study

The objective of this study was to see the impact of firm performance on compensation of independent directors, thus by using before –after design two periods of time series 2005 and 2010 was used. The purpose was to see, if the policy has any impact on these variable.

ANNEXURE-I

Sample list of 260 companies selected from Bombay stock exchange (BSE)-500 companies

3i Infotech	Blue Dart Exp.	Gateway Distr.	ING Vysya Bank	Maruti Suzuki	Shiv-Vani OilGas	Unichem Labs.
3M India	Blue Star	Geodesic	Ingersoll-Rand	Max India	Shoppers St.	Unitech
A B B	BOC India	Glaxosmit Pharma	Ipca Labs.	Mercator	Shree Cement	United Breweries
Aban Offshore	Bombay Dyeing	GlaxoSmith C H L	ITC	Monnet Ispat	Shri.City Union.	United Phosp.
Abbott India	Bosch	Glenmark Pharma.	IVRCL	Monsanto India	Shriram Trans.	United Spirits
ACC	Britannia Inds.	Godfrey Phillips	J & K Bank	MphasiS	Siemens	Usha Martin
Adani Enterp.	Cadila Health.	Godrej Consumer	J B Chem & Pharr	MRF	Simplex Infra	Uttam Galva
Agro Tech Foods.	Carborundum Uni.	Godrej Inds.	Jai Balaji Inds.	NCC	Sintex Inds.	UTV Software
Akzo Nobel	Century Textiles	Graphite India	Jai Corp	Nestle India	SKF India	V I P Inds.
Alfa Laval (I)	Cipla	Grasim Inds	Jain Irrigation	Neyveli Lignite	South Ind.Bank	Vakrangee Soft.
Alok Inds.	Clariant Chemica	Greaves Cotton	JBF Inds.	NIIT Tech.	SREI Infra. Fin.	Vardhman Textil
Alstom Projects	CMC	GTL	Jindal Poly Film	Noida Tollbridg.	SRF	Videocon Inds.
Ambuja Cem.	Coromandel Inter	Guj Gas Company	Jindal Saw	Novartis India	Sterlite Inds.	Voltas
Amtek Auto	CRISIL	Gulf Oil Corpn.	Jindal Stain.	Opto Circuits	Sterlite Tech.	VST Inds.
Amtek India	Crompton Greaves	H D F C	JM Financial	Oracle Fin.Serv.	Strides Arcolab	Whirlpool India
Ansal Properties	Cummins India	H F C L	JP Associates	Orchid Chemicals	Subex	Wipro
AP Paper	D C Holdings	Havells India	JP Power Ven.	Orient Paper	Sun Pharma.Inds.	Wockhardt
Apollo Hospitals	Dabur India	HCL Infosystems	JSW Holdings	Panacea Biotec	Sundram Fasten.	Zee Entertainme
Apollo Tyres	Deepak Fert.	HCL Technologies	JSW ISPAT	Pantaloon Retail	Supreme Inds.	Zuari Inds.
Aptech	Dewan Housing	HDFC Bank	JSW Steel	Patel Engg.	T N Newsprint	Zydus Wellness
Arvind Ltd	Divi's Lab.	HEG	Jubilant Life	Petronet LNG	Tata Chemicals	
Ashok Leyland	Eicher Motors	Hero Motocorp	Jyoti Structures	Pidilite Inds.	Tata Coffee	
Asian Paints	EID Parry	Hexaware Tech.	K S Oils	Polyplex Corpn	Tata Comm	
Aurobindo Pharma	EIH	Himadri Chemical	Kalpataru Power	Praj Inds.	Tata Elxsi	
Aventis Pharma	Elecon Engg.Co	Hind. Unilever	Kansai Nerolac	Radico Khaitan	Tata Global	
Bajaj Electrical	Electrost.Cast.	Hind.Construct.	Karnataka Bank	Rajesh Exports	Tata Inv.Corpn.	
Bajaj Fin.	Elgi Equipment	Hind.Oil Explor.	Kesoram Inds.	Rallis India	Tata Motors	
Bajaj Hindusthan	Emami	Honeywell Auto	Kirl. Brothers	Ranbaxy Labs.	Tata Power Co.	
Bajaj Holdings	Era Infra Engg.	Hotel Leela Ven.	Kotak Mah. Bank	Raymond	Tata Steel	
Balkrishna Inds	Escorts	I O C L	Kwality Dairy	REI Agro	Tata Tele. Mah.	
Ballarpur Inds.	Essar Oil	ICICI Bank	Lak. Mach. Works	Rel. Indl. Infra	TCS	
BASF India	Essar Ports	ICSA (India)	LIC Housing Fin.	Reliance Capital	Thomas Cook (I)	
Bayer Crop Sci.	Fag Bearings	IFCI	Lupin	Reliance Inds.	Timken India	
Berger Paints	FDC	India Cements	M & M	Reliance Media	Titan Inds.	
BF Utilities	Financial Tech.	India Securities	M R P L	Rolta India	Torrent Pharma.	
Bharat Electron	Finolex Inds.	Indiabulls Fin.	Magma Fincorp	Ruchi Soya Inds.	Trent	
Bharti Airtel	Fres.Kabi Onco.	Indian Hotels	Mah. Seamless	S C I	Triven.Engg.Ind.	
Bhushan Steel	G M D C	Indraprastha Gas	Mahindra Life.	S Kumars Nation	TTK Prestige	
Biocon	G N F C	IndusInd Bank	Manappuram Fin.	Sesa Goa	TVS Motor Co.	
Birla Corpn.	G S F C	Infotech Enterp.	Marico	Sh.Renuka Sugar	Uflex	

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