EXECUTIVE COMPENSATION AND CORPORATE MONITORING: A STUDY OF INDIAN FINANCIAL SECTOR

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Abstract

The executive compensation has always remained an area of interest in the corporate governance and corporate finance sector, particularly, in relation to the compensation given to top executives viz. CFO and Key Managerial personnel. Corporates have to pay an attractive amount of remuneration to the top executive to motivate them to act in the best interests of the company stakeholders. Accordingly, it happens sometimes that the managers try to get more compensation at the cost of firms' value and stockholders' interest. The purpose of this study is to assess the impact of various internal and external corporate governance supervision systems in Indian financial organisations on the amount of remuneration offered paid to senior executives. Research found the independent board and frequency of audit committee meeting, used as internal monitoring variables, had been of help in minimizing the higher Value of CEO remuneration. Perhaps the institutional Investors and activism, considered external monitoring variables, had a positive association with the CEO's compensation.

Keywords: KMP compensation; corporate governance; institutional ownership; board independence; audit structure.

1. Introduction

In the realm of corporate finance, Top Executives compensations is crucial topic. It is of utmost importance for the corporations to hire efficient executives for good policymaking, which could lead to the effective and smooth running of business operations (Slimani et al., 2014). However, the Higher Level of Management could not always be presumed to work in the favour of the shareholders because sometimes they substitute the corporate interest with the personal interest which affects the firm value in the long term. The efforts of the CEO or other top executives to gain more compensation at the cost of shareholders interest could lead to the ill health of corporates in the long-term. The two basic issues need to be dealt with regards managerial compensation firstly, the magnitude of the amount paid and secondly, the form in which such amount is paid. The form signifies the ingredients of managerial compensation, for example for the effective implementation of innovation strategy a scheme of incentives could be framed where the managerial remuneration is linked with innovation (Yanadori and Marler, 2006). So sufficiently large numbers of studies have been conducted which strives to establish the relation among firm's performance and CEO compensation

In recent years,large number of corporate frauds has emerged throughout the globe which was fueled by the demand for higher compensation by CEO. In most of these cases, it was found that the top executives were involved and their opportunistic behavior to the frauds leads to leads to corporate fall downs. It was found that most of the executives were getting higher compensation by showing the higher firm value which was purely artificial (Johnson et al. 2003). So the chances of fraud are more when the compensation linked the success of a company that is based on equity. Erikson et al. (2004) also supported the contention stating there is a positive relationship between the fraud possibility and remuneration based on equity scheme for top executives. This is interesting to study the opportunistic behavior of the top executives with regards to compensation and could be supposedly used to make the managers work for the stockholders and avoid conflicts between manager and shareholder interest.

The corporate can avoid the executive's opportunistic behavior through the implementation of a monitoring mechanism by using the corporate governance techniques (Nazir and Afza, 2018). This mechanismof governance has a tendency to reduce the possibilities of fraud in the organizations and restrains the executives from making personal gains at the cost of shareholder wealth. The literature has discussed various corporate governance mechanisms that can be either internal or external. Some of the Direct factors can be independence of the board, frequency of board meeting, the effective audit committee and the quality of the external auditor. On board presence of independent directors and Audit committee can affect CEO compensation both positively (Fernandes et al., 2012) and negatively (chhaochharia and grinstein, 2009). On the other hand, external factors could comprise of ownership structure institutional shareholders family ownership and alike. It has been observed that the Institutional shareholders have the power to monitor executive compensation (Shing-Ping and Hui-Ju, 2011). Moreover, it has been found that it is less likely for the executives to be paid higher compensation when the ownership is concentrated to the family (Cieślak, 2018). Hence, the research supports the belief of effective governance mechanism could control the opportunistic behavior of executives and could affect the on the cost of stockholder wealth, the level of CEO compensation has been deleted. Hence, the present study aims to find out the relationship of different corporate governance mechanisms being practiced in Indian financial companies with the level of the CEO's compensation.

2. Literature Review

The ability of the business executive to provide a strategic direction to organizations helps in creating and sustaining the long-term organizational value. However, sometimes a conflict of interest arises between managers and shareholders, also known as agency problem and it restrains a powerful manager to attain long term value for the organization. This deviation from the organizational goal not only creates hurdles for the firm to achieve a competitive advantage but also affects its financial orientation (Tajeddini, 2011). As per the classical theory, the managerial compensation is a remedy to deal with agency problems and helps in aligning the interests of managers with those of shareholders, and motivates them to work for overall wealth maximization of the concern. However, the problem becomes more crucial when the executives have a control on the remuneration policy of the organization (Heron and Lie, 2007) and this can only be curtailed with the well-defined corporate governance mechanism and monitoring by the owner (Bebchuk and Fried, 2003). However, no consensus has been found in the existing literature regarding which type of ownership structure plays an effective role in monitoring the insider's activities. Some studies have found that there is an inverse relationship between the controlling shareholders' ownership and CEO remuneration which become even more ambiguous if the block holders also exist in the firms (Khan et. al. 2005). Additionally, it has also been pointed out in that the institutional ownership has an inverse relationship with executive remuneration as they considered protecting the interest of minority shareholders (David et. al. 1998).

Existing research has used the number of proxies to study the effect of corporate governance tools on the behavior of executives like board structure, institutional ownership, audit committee independence and more. Moreover, it has been widely accepted that the role of the institutional investor is crucial in restricting and monitoring the business value destructive activities of corporate managers (Jong and Ho, 2018). In this regard, over the last two decades, the concept of institutional investors has evolved to effectively monitor the executive activities in comparison to passive financial institutions. As per Afza and Nazir, 2015, there are two ways in which the financial institution affects firm performance. Firstly, the Financial Institutions appoint a nominee on the board who keep an eye over the working of managers and hinder them from the exploitation of shareholder's rights. Secondly, the institutional investor just holds the stock of a company and do not interfere in any activity. So the first one or known as active institutional investors and the second one hour known as passive institutional investors.

A number of studies have been conducted, and they have carefully investigated the effect of institutional shareholder activism on the performance of the firm and have found mixed evidence. On one hand, some research studies have addressed that the active institutional investors induce executive to improve the financial disclosure quality which affects the firm performance in the long term (Gillin and Stark, 2000; Wahal, 1996). On the other hand, some studies highlighted that the organizations, where a strategic alliance of the institutional investor with the firm's management exists, bears a heavy cost in the form of bad performance (Cornett et.al.2007). Contrarily, Woidtke (2002) supported the strong relationship between institutional ownership and

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the market performance of the firm. Recently, Nazir and Afza (2018) investigated that the activism of financial shareholders ends up in mitigating the executives' behavior of managing earnings and helps in increasing the firm's value.

The institutional investor, despite mitigating the managerial agency problem, also affects the benefits and compensation dug out by top managers of the company through competent monitoring. The prior literature has shown the noticeable involvement of institutional investors in managerial opportunism and decision making (Smith, 1996). Chowdhury and Wang (2009) studied the role of institutional shareholders' activism in monitoring the CEO incentives in Canada and showed that the board's independence and activism of institutional shareholders' upsurge the compensation of CEOs. Similarly, Hartzell and Starks (2003) found that the attention of active financial shareholders negatively influences executive compensation. They were unsuccessful in establishing a reverse casualty between executive compensation and institutional investors. Additionally, the study stressed on the simultaneous effects of compensation level, institutional investors and monitoringand observed that this correlation prevailed where monitoring was done through the stock market, outside equity holders (Burkart et al., 1997) and institutional investors, simultaneously. Since institutional investors have some costs and benefits (Shleifer and Vishny, 1986; Huddart, 1993) associated with them, so the relationship between managerial incentives and monitoring is based on cost and benefit analysis. The monitoring cost arises when investors need additional resources to take managerial actions (Noe, 2002). Likewise, incentive compensation exerts the burden on shareholders and minimizes the agency cost (Hartzell and Starks, 2003). Recently, Irani and Gerayeli (2017) also investigated a significant relationship between the monitoring of financial institutional shareholders and managerial compensation in Iran. Furthermore, Ming et al. (2018) discussed the role of foreign institutional investor's activism and stated that institutional shareholding significantly moderates the pay-for-performance relationship by fading the positive relationship between firm performance and CEO compensation.

With respect to the monitoring mechanism of corporate governance, the relationship between executive compensation and audit committee effectiveness has been discussed in existing studies in the context of audit costs. An effective monitoring role of audit committee minimizes the need for costly external audit and gives strength to the internal control system. Similarly, if executive compensation reduces the conflicting interests of managers and shareholders under incentive alignment hypothesis, it can minimize the need for external auditing (Vafeas andWaegelein, 2007), which in turn would reduce the audit costs. On the other hand, in firms with family ownership, the remuneration is a reason for earning manipulation which upsurges the external cost of auditing (Bedard and Johnstone, 2004) and entails more audit efforts (Gordon, 2002) presenting a positive association between executive compensation and audit efforts.

Furthermore, the literature has also discussed the role of independent board as a monitoring mechanism of good corporate governance system which affects the CEO compensation (Almazan and Suarez, 2003; Saravanan et al., 2016; Elston and Zhang, 2016) which is an important center for internal monitoring on CEOs (Adams and Ferreira, 2007). The literature has widely regarded Board independence as the most effective instrument for monitoring organizational decisions (Brown and Caylor, 2006). However, the existence of a strategic alliance between executive directors and independent board members makes the efficient monitoring role of independent boards suffer (Klein, 1998; Shivdasani and Yermack, 1999). Eventually, such mingled independent directors pay attention to their personal benefits and neglect the monitoring responsibilities on top executives (Westphal and Zajac, 1995) which permits them to extract excessive compensation and private benefits at the cost minority shareholders (Irani and Gerayeli, 2017). So a right independent board with active participation is needed for efficient monitoring of executives activities and control over the CEO compensation (Asfandyar et al., 2013; Nazir, 2016).

The focus of this research paper is to gauge the impact of the monitoring mechanism, both external and internal, of corporate governance on CEO compensation of Indian financial companies. For the aim of study, the ownership by financial institutions and their activism has been taken as external monitoring mechanism whereas audit structures and board characteristics are wont to evaluate the amount of internal monitoring mechanism of monetary incentives of top managers. CEO compensation incorporates a prominent role in to ply in deteriorating or enhancing firm value. Specifically, the Indian economy is suitable to analyze this relationship because the Indian corporate sector is heavily supported concentrated shareholding, externally and internally. Additionally, the amount and role of monetary institutions are growing since the previous couple of decades. So, it's important and interesting to check whether these organizations misappropriate minority shareholders' money through highly paid CEOs or efficient monitoring is acting as assist in monitoring this managerial opportunism. Within the Indian context, only a few studies are conducted focusing on exploring the connection of ownership and control with organizational performance, however, the CEO compensation has been rather ignored. Moreover, no study might be found that focuses entirely on the financial sector. The prevailing literature mostly targeting the determinant of managerial compensation in India whereas, the investigation of CEO compensation within the presence of monitoring mechanism remained underexplored. The current study is an endeavor to fills this research gap by studying the impact of institutional ownership and their activism (external monitoring) and board characteristics and audit structure (internal monitoring) on CEO compensation within the context of the Indian financial sector

3. Research methodology

Listed Financial Companies at BSE on 31st December 2019 and forming part of the S&P BSE Finance Index are taken as a target population for the study. In this, 105 companies are choosen for the study after screening for outliers and data availability. The study is conducted during the period 2008-09 to 2018-19. We collected 1050 firm-year cross-sectional observations. Data is gathered from annual reports of selected corporations, as well as stock market-related factors from the PROWESS database. The following regression equations have been modeled to study the effect of the monitoring mechanism on CEO compensation:

$$\boldsymbol{CEO\_COM_{it}} = \alpha + \beta_1 INS\_Act_{it} + \beta_2 FAM\_OS_{it} + \beta_3 ACI_{it} + \beta_4 B\_Ind_{it} + \beta_5 B\_Act_{it} + \beta_6 Dual_{it} + \beta_7 ROA_{it} + \beta_8 TobinQ_{it} + \beta_9 Size_{it} + \varepsilon_{it} \quad (1)$$

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Where
CEO_COM_{it}: CEO compensation measured as of natural log of aggregate compensation
INS_OS_{it}: proportion of financial institutions ownership
INS_Act_{it}: institutional shareholders' activism
FAM_OS_{it}: proportion of family ownership
ACI_{it}: audit committee independence
B_Ind_{it}: board independence measured as proportion of non-executive directors to total board members
B_Act_{it}:board activity measured as frequency of board meetings in a financial year
$Dual_{it}$: CEO duality
ROA_{it}: accounting performance measured as return on assets
$TobinQ_{it}$: market performance measured as Tobin's Q
$Size_{it}$: firm size measured as natural log of total assets
ε_{it}: error term.
'i' and 't' denote the firm and year respectively.

Top management compensation are one of the most significant elements that assist in boosting the motivation level of top executives, which leads to improve firm value. Compensation for top executives (including the CEO) is divided into several categories, including cash salaries, bonuses, pensions, stock options, and other benefits. CEO compensation is a dependent variable in this study, and it is calculated by adding the cash remuneration (such as salary and bonus) and all other non-monetary components received by the CEO over the course of a financial yearIt can be thought of as a lump sum payment to the independent variable of the corporate governance monitoring mechanism. With respect, the literature has used two effective monitoring mechanisms namely internal monitoring mechanism and external monitoring mechanism. Independent boards and audit structure forms part of an internal monitoring mechanism whereas ownership held by financial institutions reflects the external monitoring mechanism. Both approaches are intended to align the interests of minority and majority shareholders, as well as to reduce agency costs and concerns in businesses. The institutional ownership in this study was calculated as a percentage of total shareholdings held by financial institutions. Similarly, institutional shareholders' activism is measured using a dummy variable that is set to 1 for enterprises where financial institution nominees are present (active shareholders) and 0 otherwise. In addition, the proportion of total shares held by family members to total shareholding is used to measure family ownership.

Audit committee independence, board independence, CEO duality, and board activity have been employed as independent variables of corporate monitoring from the standpoint of internal corporate monitoring. The proportion of independent board members to total board size, a frequent proxy for independent boards, has been used to measure board independence. The audit committee's independence has been measured using a similar manner. CEO duality is a dummy variable that represents the CEO's ability to reap personal benefits. It takes a value of 1 if the CEO is also the chairman of the board of directors, and 0 otherwise. Finally, board activity is a measure of the board's performance, and this study measures board activity by the frequency of board meetings over the course of a fiscal year.

The current study used ROA and Tobin's Q, accounting and market performance measures, as control variables for determining CEO compensation. ROA is calculated by dividing a firm's net income by total assets, a method also used by Wu (2013), whereas Tobin's Q is a better way to calculate a firm's market value based on the use of assets and growth opportunity (Tasawar et al., 2018). It also reveals investors' expectations for a company's future prospects, as well as the impact of business strategy on future performance (Demsetz and Villalonga 2001). Tobin's Q is calculated as the sum of total liabilities' market capitalization and book value divided by total assets. Finally, the firm's size can help explain things.

4. Results and Discussion

Table 1 displays descriptive statistics for the data under investigation. According to the numbers in the table, the average level of CEO salary for sample companies during the study period was 8.268 million INR, with a standard deviation of 3.479 million INR. The percentage of the total stake owned by family members ranges from zero to 91.96 percent, with an average of 22.24 percent. Financial institutions, which include banks, mutual funds, insurance companies, and other institutional investors, hold an average of 17.70 percent of the total shares in the tested companies, as shown in the table. Institutional investors own a sizable portion of the market. The table demonstrates that a nominee of financial institutions is present on the balance sheet of 29.71 percent of the sample enterprises.

Table 1: Descriptive statistics

Continuous Variables	Min.	Max.	Mean	S.D.
CEO_COM (million IND Rs)	0	15.088	8.268	3.479
INS_OS (%)	0	87.593	17.700	13.780
FAM_OS (%)	0	91.966	22.243	27.253
ACI (%)	0	100	80.903	21.061
B_Ind (%)	1.886	87.023	43.032	34.114
B_Act	3	36	7.282	3.368
ROA (%)	-37.845	89.017	6.191	17.631
TobinQ	0.480	8.256	2.304	2.497
Size (in billion IND Rs.)	0.010	29.840	13.161	30.012

Dichotomous Variables	Frequency	%age
INS_Act	312	29.71
Dual	465	44.28
N	1050	

The regression findings for examining the association between corporate monitoring mechanisms and CEO salary in companies are presented in Table 2. Table 2 shows Model-1, which uses financial institutional ownership as a proxy for external institutional monitoring, and Model-2, which employs dummy variables to study the effect of shareholder activism in monitoring CEO salary. Table 2 shows that at the 5% level of significance, both Models-1 and Model-2 are well-fitting, with F-values of 41.77 and 44.57, respectively. In terms of dependent variables, both models predict a variation of about 26%. The Durbin Watson test value also suggests that the response and residuals variables have a lower chance of autocorrelation, which is a desirable thing.

Table 2 reveals that institutional shareholdings and activism, two variables utilised by financial institutions for external monitoring, had a positive relationship with CEO salary in the sample firms over the study period. This favourable association between external monitoring and CEO salary could be owing to institutional investors' less careful scrutiny of managerial opportunistic behaviour (Chowdhury and Wang, 2009). On the other hand, this positive association is substantially offset by family ownership, which has a statistically significant negative relationship with CEO salary, implying that family businesses pay their CEOs less (Croci et al., 2012; Tasawar et al., 2018). The data support the strategic alliance hypothesis, which suggests that institutional investors' ineffective role may be related to social engagement with them.

The presence of independent directors in the audit committee and board of directors, on the other hand, has a negative impact on the amount of CEO compensation in sample companies when it comes to internal monitoring. Table 2 reveals that both audit committee independence and board independence, both internal monitoring variables, have a negative connection with CEO salary. In the case of Model-1, however, board independence is statistically negligible. It demonstrates that a company's internal audit system is effective in preventing CEOs from receiving excessive compensation. Furthermore, board activism, as measured by the number of board meetings, demonstrates its effectiveness by lowering CEO compensation (Conyon and Peck, 1998; Tasawar et al., 2018).

Table 2: Regression analysis of corporate monitoring and CEO compensation

Variables	**Model 1**			**Model 2**		
	β	**t-value**	**p-value**	**β**	**t-value**	**p-value**
(Constant)	0.103	0.114	1.045	-0.092	-0.102	1.054
INS_OS	1.798	3.090	0.008	--	--	--
INS_Act	--	--	--	0.661	4.478	0.000
FAM_OS	-0.969	-2.546	0.028	-1.033	-2.732	0.018
ACI	-0.961	-2.115	0.072	-0.901	-1.988	0.091
B_Ind	-0.137	-0.484	0.761	-0.156	-0.549	0.715
B_Act	-0.052	-2.140	0.068	-0.050	-2.057	0.080
Dual	-0.328	-2.093	0.075	-0.374	-2.394	0.040
ROA	1.362	3.010	0.009	1.306	2.898	0.012
TobinQ	0.002	0.809	0.542	0.002	0.767	0.568
$Size_{it}$	0.525	11.407	0	0.533	11.613	0
F-value		41.777*			44.571*	
Adjusted R^2		26.003			26.423	
D-W		1.663			1.667	

**Note: ****Shows level of significance at 5%.*

5. Conclusions

The current study contributes to the knowledge of the relationship between corporate monitoring and CEO pay in India's financial industry, thereby filling a vacuum in the literature. The new study adds to our understanding of the relationship between corporate monitoring and performance. (internal and external) and CEO compensation, taking into account and investigating financial institutional activist shareholders. By receiving exorbitant compensation, the CEO takes more private benefits for themselves while misappropriating the wealth of the shareholders. Effective internal and external monitoring mechanisms, on the other hand, have a propensity to minimise CEOs' opportunistic conduct. The findings of this study backed up the agency theory's strategic alliance hypothesis and refuted the efficient monitoring hypothesis, Top executives of banking institutions have been let go, according to reports.

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