

UNIT 3 COMPONENTS OF COMPENSATION

COMPENSATION

- Compensation refers to the total package of financial and non-financial rewards provided to employees in return for their services. A well-designed compensation system ensures **internal equity, external competitiveness, legal compliance, and employee motivation**. Modern organizations follow a **Total Compensation Approach**, which includes fixed pay, variable pay, benefits, and long-term incentives.

FIXED COMPENSATION

- **I. Fixed Compensation (Base Pay)**
- **Meaning**
- Fixed compensation is the **guaranteed portion of salary** paid regularly (monthly) irrespective of individual or organizational performance. It provides income stability and financial security to employees.
- **Characteristics**
 - Predictable and stable income
 - Paid for time worked or position held
 - Forms the base for statutory calculations

COMPONENTS OF FIXED COMPENSATION

- **(a) Basic Salary**
- Core element of compensation
- Usually 30–50% of total salary
- Basis for calculating PF, Gratuity, Bonus, and DA
- Reflects job value and skill level
- **(b) Dearness Allowance (DA)**
- Paid to neutralize the effect of inflation
- Mainly applicable in government and public sector
- Linked with Consumer Price Index (CPI)
- Revised periodically

COMPONENTS OF FIXED COMPENSATION

- **(c) House Rent Allowance (HRA)**
- Paid to meet housing expenses
- Partially tax-exempt under Income Tax Act
- Depends on city classification
- **(d) Special Allowance**
- Residual component to balance salary structure
- Fully taxable
- Does not carry statutory benefits

IMPORTANCE OF FIXED COMPENSATION

- **I. Income Security and Financial Stability**
- Fixed compensation provides employees with **assured and predictable income**, enabling them to meet regular expenses such as rent, food, education, and healthcare. This financial stability reduces stress and enhances focus on work.
- **2. Basis for Statutory and Retirement Benefits**
- Fixed pay, especially **Basic Salary and Dearness Allowance**, forms the basis for calculating statutory benefits like:
 - Provident Fund (PF)
 - Gratuity
 - Bonus
 - Superannuation
- Thus, higher fixed compensation leads to better long-term social security.

IMPORTANCE OF FIXED COMPENSATION

- **Supports Long-Term Financial Planning**
- Employees can plan savings, investments, loans, and retirement effectively due to the certainty of fixed income. It encourages responsible financial behavior.
- **Motivation for Consistent Performance**
- Although not directly performance-linked, fixed compensation motivates employees to maintain **steady and reliable performance**, especially in roles where output is difficult to measure.
- **Attracts Talent in Risk-Averse Roles**
- In administrative, academic, government, and support functions, employees prefer **stable pay over variable incentives**, making fixed compensation a strong attraction tool.

CASH BENEFITS AND ALLOWANCES

- Cash benefits are **additional monetary payments** provided to employees to meet specific personal or work-related expenses.

Allowance Type	Purpose
Conveyance Allowance	Travel to workplace
Medical Allowance	Healthcare expenses
Leave Travel Allowance (LTA)	Travel during leave
Education Allowance	Children's education
Uniform Allowance	Work attire

ROLE OF CASH BENEFITS

- Improve standard of living
- Provide tax planning opportunities
- Increase perceived compensation value

RETIRALS AND SOCIAL SECURITY BENEFITS

- Retiral and social security benefits provide **income security after retirement** and protect employees from life contingencies such as illness, disability, and death.

RETIRALS AND SOCIAL SECURITY BENEFITS

- **(a) Provident Fund (PF)**
- Mandatory retirement savings scheme
- Governed by EPF Act, 1952
- Contribution:
 - Employee: 12% of Basic + DA
 - Employer: 12% of Basic + DA
- Tax-exempt and long-term savings
- **Importance:**
Ensures post-retirement financial security and disciplined savings.

RETIRALS AND SOCIAL SECURITY BENEFITS

- **(b) Employees' State Insurance (ESIC)**
- Applicable to employees below wage ceiling
- Provides social insurance
- **Benefits include:**
 - Medical care
 - Sickness benefit
 - Maternity benefit
 - Disablement benefit

RETIRALS AND SOCIAL SECURITY BENEFITS

- **(c) Gratuity**
- Lump-sum payment after retirement/resignation
- Eligibility: Minimum 1 years continuous service

- **Calculation:**

$$\text{Gratuity} = (\text{Last drawn Basic} + \text{DA} \times 15 \times \text{Years of Service}) / 26$$

- **Purpose:**

Reward for long and continuous service.

RETIRALS AND SOCIAL SECURITY BENEFITS

- **(d) Superannuation**
- Employer-sponsored pension scheme
- Contributions made to a pension fund
- Optional but common in large organizations

- **Advantage:**

Provides additional retirement income.

VARIABLE PAY / INCENTIVES

- Variable pay is **performance-linked compensation** that varies based on individual, team, or organizational performance.
- **Objectives**
- Encourage higher productivity
- Link pay with performance
- Reward exceptional contribution

TYPES OF VARIABLE PAY

- **(a) Short-Term Incentives (STI)**
- Paid within a year
- Sales incentives
- Productivity bonus
- Performance bonus
- **(b) Long-Term Incentives (LTI)**
- Deferred rewards
- Retention bonus
- Profit sharing

TYPES OF VARIABLE PAY

- **Advantages**
- Promotes pay-for-performance culture
- Flexible cost for employer
- Enhances motivation
- **Limitations**
- Income uncertainty
- May encourage short-term focus

STOCK OPTIONS (ESOPS)

Meaning

- Employee Stock Option Plans (ESOPs) give employees the **right (not obligation)** to purchase company shares at a predetermined price after a vesting period.
- **Key Terms**
- **Grant Date** – Date options are offered
- **Vesting Period** – Minimum service period
- **Exercise Price** – Pre-decided price
- **Exercise Period** – Time to buy shares

STOCK OPTIONS (ESOPS)

- **Objectives of ESOPs**
- Retain key talent
- Create employee ownership
- Align employee and shareholder interests

STOCK OPTIONS (ESOPS)

- **Advantages**
- Long-term wealth creation
- Encourages loyalty
- No immediate cash outflow
- **Limitations**
- Market risk
- Complex valuation
- Not suitable for all employees

COST TO COMPANY

- **Cost to Company (CTC)** refers to the **total annual cost incurred by an employer on an employee**. It includes:
 - Direct cash payments
 - Statutory contributions
 - Retirement and social security benefits
 - Welfare costs
 - CTC ≠ Take-home salary

COST TO COMPANY

- **Components Included in CTC**
- CTC broadly consists of:
 - Fixed Pay
 - Allowances & Cash Benefits
 - Statutory Contributions
 - Retirement & Social Security Benefits
 - Bonus
 - Inflation-linked compensation (DA)

COSTING OF FIXED COMPENSATION

- **Costing of Fixed Compensation**
- **(a) Basic Salary**
- Core component of salary
- Typically 30–50% of CTC
- **Forms the base for PF, Gratuity, Bonus, DA**
-  **Costing:**

Employer bears the full Basic Salary amount as part of CTC.

COSTING OF FIXED COMPENSATION

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- **b) Dearness Allowance (DA)**
 - Paid to neutralize inflation
 - Mostly in government/public sector
 - Linked with CPI
 -  **Costing:**
Included fully in CTC and also considered for:
 - PF
 - Gratuity
 - Bonus
 - **Allowances (HRA, Special Allowance, etc.)**
 - Paid monthly
 - Mostly fully taxable (except limited exemptions)
 -  **Costing:**
Entire allowance amount is included in CTC.

COSTING OF PROVIDENT FUND (PF)

- Provident Fund is a **mandatory retirement savings scheme** under the EPF Act, 1952.
- If Basic + DA = ₹30,000/month
Employer PF = 12% = ₹3,600/month
Annual PF cost = ₹43,200

Contributor	Rate
Employee	12% of Basic + DA
Employer	12% of Basic + DA

COSTING OF ESIC

- Employees' State Insurance Scheme provides **medical and social security benefits**.
- Only **Employer's ESIC contribution** is included in CTC.

Contributor

Rate

Employer

3.25% of gross wages

Employee

0.75% of gross wages

COSTING OF GRATUITY

- Gratuity is a **statutory lump-sum benefit** paid after minimum 1 years of service.
- **Formula**
- $\text{Gratuity} = (\text{Last drawn Basic} + \text{DA} \times 15 \times \text{Years of Service}) / 26$
- **Accounting for CTC**
- Organizations generally **provision gratuity annually**.
- **Annual Gratuity Cost (approx.)**
 $= 4.81\% \text{ of Basic} + \text{DA}$
- **CTC Impact:**
Employer's gratuity provision is included in CTC.

COSTING OF SUPERANNUATION

- Superannuation is an **employer-sponsored pension scheme**.
- **Contribution**
- Employer contributes up to **15% of Basic salary**
- Optional benefit
-  **CTC Impact:**
Employer's contribution to superannuation fund is included in CTC.
-  **Advantage:**
Tax-efficient retirement planning for employees.

COSTING OF BONUS (PAYMENT OF BONUS ACT, 1965)

- **Applicability**
- Employees earning within statutory wage ceiling
- Establishments with 20 or more employees
- **Rate of Bonus**
- Minimum: **8.33%**
- Maximum: **20%**
- **Calculation Base**
- Basic Salary or statutory ceiling, whichever is lower
- **CTC Impact:**
Bonus payable by employer is added to CTC as an annual cost

UNDERSTANDING INFLATION IN COMPENSATION

- Inflation refers to a **continuous rise in the general price level**, reducing purchasing power of money.
- **Impact on Employees**
- Real income decreases
- Cost of living increases
- Wage dissatisfaction rises

NEUTRALIZATION OF INFLATION – DEARNESS ALLOWANCE (DA)

- Dearness Allowance is paid to **compensate employees for inflationary pressures**.
- **Features**
- Linked to CPI
- Revised periodically
- Common in government and PSU sectors
-  **CTC Impact:**
DA is fully included in CTC and affects:
 - PF
 - Gratuity
 - Bonus

CONSUMER PRICE INDEX (CPI)

- CPI measures the **average change in prices of a basket of consumer goods and services** over time.
- **Uses in Compensation**
- Basis for DA calculation
- Wage revision
- Cost of living adjustments
-  **Role in CTC Planning:**
CPI indirectly influences compensation costs through DA revisions.

Component	Included in CTC
Basic Salary	✓
DA	✓
Allowances	✓
Employer PF	✓
Employer ESIC	✓
Gratuity Provision	✓
Superannuation	✓
Bonus	✓
Stock Options	✗ (Excluded)