

# UNIT 3 COMPONENTS OF COMPENSATION

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# COMPENSATION

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- 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

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- **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

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- **(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

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- **(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

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- **1. 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

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- **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

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- 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

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

# RETIRALS AND SOCIAL SECURITY BENEFITS

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- 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

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- **(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

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- **(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

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- **(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

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- **(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

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- 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

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- **(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

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- **Advantages**

- Promotes pay-for-performance culture
- Flexible cost for employer
- Enhances motivation

- **Limitations**

- Income uncertainty
- May encourage short-term focus

# STOCK OPTIONS (ESOPS)

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## 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)

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

# STOCK OPTIONS (ESOPS)

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- **Advantages**

- Long-term wealth creation
- Encourages loyalty
- No immediate cash outflow

- **Limitations**

- Market risk
- Complex valuation
- Not suitable for all employees

# COST TO COMPANY

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- **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  $\neq$  Take-home salary

# COST TO COMPANY


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- **Components Included in CTC**

- CTC broadly consists of:
  - Fixed Pay
  - Allowances & Cash Benefits
  - Statutory Contributions
  - Retiral & Social Security Benefits
  - Bonus
  - Inflation-linked compensation (DA)

# COSTING OF FIXED COMPENSATION



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- **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)

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- 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

Employee

Employer

## Rate

12% of Basic + DA

12% of Basic + DA

# COSTING OF ESIC

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- 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

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

# COSTING OF SUPERANNUATION

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- 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)

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- **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

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- 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)

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- 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)

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- 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)