Profit, Dividend and Financial Compensation: Empowering Shareholders, A Proposal

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Abstract. *Recent crisis and failure of some major corporation that shook the business world was inspiration for this paper. This paper proposes to link top executives and as well as the employees of the firm to the profit generated by the firm. It proposes to empower the shareholders to approve debts application of the firm and fixing the bottom most salary. Being a shareholder is being the owner of the firm and hence the shareholder must have first claim over the profit, so the paper recommends mandatory annual distribution of profit's portion as dividend. The paper produces a chart and tables to further simplify and substantiate the idea.*

Keywords: *Profit, Dividend, Compensation, Empowering Shareholders*

Today and in past, many well-known and lesser known shareholding companies have failed. Failure is not necessarily due to decisions taken but it could be due to multifaceted factors. It could be the right decision / product but the wrong marketing; it could be due to changes in political preferences, or due to changes in the business environment or due to new invention / technology. With failure comes a financial consequence which effects shareholders' positions, and, in the case of closure, the employees and other stakeholders being affected as well. Recent failures that shook the largest economy of the world and created ripples in the world economy included companies tagged as "too big to fail". The companies that failed or were bailed out by the leading capitalist countries (Laissez-faire) were companies such as Enron, ABN Amro, Royal Bank of Scotland, GM, MG Rover, JP Morgan Chase, Goldman Sachs, Lehman Brothers, AIG, Wachovia, etc.. These were dream companies, which every executive wished to join. These companies

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compensated their executives very well especially the senior ones, but then one should ask why? Why did some companies pay their top executives and CEO's so highly and yet those companies failed? The fact that the companies go bust or incur losses in spite of the presence of these well rewarded CEOs is a matter of concern.

This paper proposes to link the compensation of the CEO and the general employees to profit. Engaging all stake holders, especially the employees, would yield a better profit. The higher the company's profit the higher would be the pay for their employees from top to bottom. The 'benefits' to the employees should be declared from net profit in a fixed ratio.

Profit

The profit we are referring to here is accounting profit, which is defined as "the revenue realised in a given period after providing for expenses incurred …… . The accountant deducts explicit costs from the revenue in order to determine profit."(1) When a profit is made the biggest claimant of this profit should be the shareholders. When there is a profit in a firm, a percentage of the profit must be shared with the employees and shareholders of the firm. There are number of studies and practices that indicate that profit sharing is in the interest of the company. According to John Gennard and Graham Judge "these schemes aim to increase employee motivation and commitment by giving employees an interest in overall performance of the enterprise. In this way management hopes to raise employees' awareness of the importance of the profit to their organization and to encourage team working by demonstrating that it rewards acumen from cooperative effort even more than individual effort. Profit sharing schemes ensure that employees benefit from the organization making profits."(2) Jason Riley(3) thinks profit-sharing plans in small firms can help to enhance employee commitment and increase the job related performance of the individuals.

(1) TR Jain & OP Khanna (2010), Business Economics, p. 349.
(2) John Gennard and Graham Judge (2005), Employee Relations, p. 195.
(3) Jason Riley, "The Election Choice: Union" *The Wall Street Journal*, October 27, 2008, A19.

The profit sharing concept has the support of many scholars such as Albert Gallatin, John Stuart Mill, William Stanley Jevons, Linda Bell[1], Douglas L. Kruse[2], Martin Weitzman[3], John V .Duca David D. VanHoose[4], and others. This mechanism gives the feeling that the company is making profit because of its employees. In the words of A. C. Fernando, "Profit sharing motivates the individual worker to put in his best as his efforts are directly related to the profits of the organization, in which he gets a share."[5] The study conducted by Hua Wang concludes that "The regression results show that the profit sharing plan has a significant negative effect on a firm's exit hazard, which means the adoption of profit sharing will help a firm live longer. The results are consistent across different measurements of profit sharing."[6] The most significant importance of the profit-sharing principle is given in the words of Scott A. Snell and George W. Bohlander, "profit sharing plans are intended to give employees the opportunity to increase their earnings by contributing to the growth of their organization's profits."[7] Indeed, the increase in the earning of the employees would also result in the increased earning of the shareholders.

The primary reason why anyone invests in any business is to earn extra income. The shareholders are actually the owners of the firm; hence they must have the upper hand / say on the strategic affairs of the company. The strategic error done by the firms 'Typically, the percentage of the profit distributed to employees is set by the end of the year before distribution'[8]. To achieve the benefit attributed above to the profit-sharing

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(1) David T. Ellwood (2000), A Working Nation: Workers, Work, and Government in the New Economy, p. 82.

(2) Douglas L. Kruse (November 1993) , Does Profit Sharing Affect Productivity?, NBER Working Paper No. w4542

(3) Weitzman M. (1985;December), The Simple Macroeconomics of Profit Sharing. *American Economic Review*.

(4) John V. Duca & David D. VanHoose (November 1997), Goods-Market Competition and Profit Sharing: A Multisector Macro Approach, Federal Reserve Bank of Dallas.

(5) A.C. Fernando (2006), Corporate Governance: Principles, Policies and Practices, p. 172.

(6) Hua Wang (2006), The Effects of Employee Stock Ownership and Profit Sharing on Firm Survival, UMI, p. 83.

(7) Scott A. Snell, George W. Bohlander (2011), Managing Human Resources, 16th ed., p. 455.

(8) Robert L. Mathis and John Harold Jackson (2010), Human Resource Management, p. 408.

mechanism, the firm must commit the profit sharing mechanism in advance for all employees, mangers, board of directors, etc.

Strains on Profits

The profit made through the serious combined efforts of the employees, management and board, gets eroded due to some decisions taken, thought to enhance business but sometimes just out of greed to expand beyond ones capacity/capabilities. In either case it is borrowing on interest, except if it is done by way of equity expansion. Companies expanding through interest based borrowing have to cough up interest on the borrowing, even if the firm has not yet benefited from this borrowing. And, if the business environment turns to be unfavorable, it further compounds the problem. Serving debt (interest/usury) has always put considerable strain on the profit of the firm and ultimately affects the returns to shareholders. Professor Ndikumana's research confirms the negative relation between debt and profit of firm. He concludes "The results in this paper (Debt service, financing constraints, and fixed investment: evidence from panel data) establish a negative relation between investment and debt service beyond the fact that debt service reduces cash flow. The findings support the hypothesis that cash payment commitments reduce the ability of a firm to sustain investment in the case of a squeeze on profits and sales."[1] Some of the large firms try acquisition and hostile takeovers by excessive borrowing at high interest rates. These aggressive purchase / takeover / acquisition are mostly done through aggressive borrowing in the market. There are many researches[2]

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(1) Leonce Ndikumana (1999), Debt service, financing constraints, and fixed investment: evidence from panel data, *Journal of Post Keynesian Economics*, Spring 99, Vol. **21** Issue 3, p. 455.

(2) A. Schleifer and R.W. Vishny, Takeovers in the 60s and 80s: Evidence and implications,"Strategic Management Journal December 1991, p. 51. R. Roll, Empirical Evidence on Takeover Activity and Shareholder Wealth", Knights, Raiders and Targets, 1989, p. 112. R.E. Caves, Merger, Takeovers, And Economic Efficiency, International Journal of Industrial Organization July (1998) p. 151. T.H. Brush Predicted changes in operational synergy and Post Acquisition Performance of Acquired Business", *Strategic Management Journal*, v 17-1, January, 1996, p. 1. T. Loughran and A.M. Vijh, Do Long Term Shareholders Benefit from corporate Acquisitions? *Journal of Finance*, **5** 1997, p. 1765. M.C. Jensen and R.S. Ruback, "The Market for Corporates Control: The Scientific Evidence," *Journal of Financial Economics,* November (1983) p. 5.

suggesting that acquisitions fail to increase the profitability of the acquiring company and may result in losses[1]. Another study suggest that company's market value and profitability declines, rather destroys the value of the company instead of creating.[2]According to Vadapalli, “Debt servicing costs can reduce earnings performance directly. Since Acquisitions are associated with high debt levels, it is an uphill battle to make them profitable. High levels also increase the likelihood of bankruptcy, which can lead to a downgrade in the firm’s credit rating from rating agencies.”[3] Servicing debts naturally reduces the profit of the shareholder (dividend) in words of Gabriel, “Debt can eat away at shareholder equity and overall value of the business.”[4] I am not suggesting that there has to be zero debt only. But, unnecessary debt must be avoided. It is wise to expand prudentially at one’s own cost or through interest-free mechanisms, if possible. Gabriel Wisdom puts it in following words; “The best debt-to-equity ratio, of course, is zero. But I might shy away from a company with debt-to-equity ratio higher than 25 percent.”[5]

While Shariah complaint Muslim investors are required to invest in a firm that firstly meets the Shariah requirement of not being in Haram (prohibited) business and debt to equity[6]or Asset [7]ratio not exceeding 33%. This is the accepted standard adopted by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions)[8]; the Shariah

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(1) Charles W. L. Hill, Gareth R. Jones (2012), Strategic Management Theory: An Integrated Approach, p. 365.

(2) D.J. Ravenscraft and F.M. Scherer (1987), Mergers, Sell-offs, and Economic Efficiency, Washington: Brooking Institution.

(3) Ravinder Vadapalli (2007), Mergers Acquisitions and Business Valuation, p-148.

(4) Gabriel Wisdom (2009), Wisdom on Value Investing: How to Profit on Fallen Angels, p. 21.

(5) ibid

(6) Rasem N. Kayed & Kassim M. Mohammed (2009), Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks, *Journal of Islamic Economics, Banking and Finance*, Volume-5 Number-3, p. 12
Marwan Al-Turki, Debevoise & Plimpton (June 2007), Shariah-compliant Private Equity Funds: What Private Equity Managers Need to Know, http://www.eurekahedge.com/

(7) Natalie Schoon (2010), Islamic Banking and Finance, p. 117.

(8) http://www.aaoifi.com

standard 21[1] states the standard that deals with Financial papers (Shares and Bonds). These restrictions are indeed needed and are important for protecting the firms, shareholders and employees. Perhaps that is the reason why Islamic investments have proven to be more resilient[2] to crisis and have fared well[3] during the financial crisis. Shareholders must have a say when firms want to enter debt deals beyond or equal to 3% Debt to Asset or equity ratio. A simple majority must approve it. Similarly, if a company wishes to exceed a Debt to Equity/Asset ratio above 15% it must get the approval of two third of the shareholders. But, it should not cross the 33% Debt to Asset / Equity Ratio. These are conservative and best approach to safeguarding the interest of the shareholders and all employees.

Compensations

Financial Compensation paid to employees from top to bottom has to be structured in such a way that it meets the average market standard; it retains the needed staffs and compensates them annually for their achievements. Many firms tend to pay in excess to their employees simply in order to retain them. Retention is good but not the blackmail, as some employees express their intention to leave at a crucial time. Excessive payments to such disloyal employees are unfair. And the compensation package developed by large corporations for their senior managements and CEOs actually eats away shareholders' profits[4]. There is indeed a need to check the level of direct compensation paid to executives and top management; a few years back it was reported in The Economics Time that former corporate affairs minister of India Salman Khurshid had said "companies should avoid paying their top executives what he termed 'vulgar salaries'"[5]. Earlier than that, the prime minister of India, Manmohan Singh, was reported as "exhorting top executives to

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(1) http://www.irti.org/irj/go/km/docs/documents/IDBDevelopments/Internet/English/IRTI/CM/downloads/Distance_Learning_Files/Spring2009/AAO-Standard%2021-1E.pdf

(2) Islamic Banks: More Resilient to Crisis?, (Global Economic Crisis), IMFSurvey Magazine: IMF Research, October 4, 2010

(3) John Graham and Scott B. Smar (2011), Introduction to Corporate Finance, 3rd ed. (ch 13 Characteristics of Long-Term Debt Financing).

(4) Lucian A. Bebchuk and Jesse M. Fried (2006), Pay Without Performance: The Unfulfilled Promise of Executive Compensation, p. 63.

(5) The Economics Times, September 7 2010.

show some moderation in executive pay"[1].During the financial crisis, MSNBC (2009) reported: "President Barack Obama imposed a $500,000 cap on senior executive pay for the most distressed financial institutions receiving taxpayer bailout money and promised new steps to end a system of "executives being rewarded for failure."[2] In June 2012, The Guardian (UK) carried the following headline "French finance minister says cap on top pay is 'moral issue' (with following subheading) Pay squeeze delivers on a campaign promise by France's Socialist president François Hollande."[3] The French Finance Minister put a cap of € 450,000[4] on top executives. The fixed excessive pay has become outrageous and hence it must be brought down and equated with performance. Hence I believe it would be prudent that top executive's fixed pay must not exceed 12 times[5] that of the lowest paid employee of that firm including full time contracted employees. Hence the shareholders should have the right to fix the salary of the bottom most in the firm and the maximum cap for the top most is a known (12 times the bottom most).

Dividend

"'Dividend' generally means distributions of profits to the shareholders of a company as a return on the capital that the shareholders have made available to the company as its shareholders."[6] Dividends are distributed after tax (and interest) deduction from gross profit. The company can 'retain' the profit after tax or distribute the profit to shareholders as 'dividend' or both. Dividend incomes are taxed in some countries and not in others to avoid double taxation as dividend is declared from profit after tax which is net profit. The countries that charges tax on dividend must abolish these taxes. The very purpose behind the common man becoming a shareholder is to primarily make money; hence it should be made mandatory for the companies to pay dividends whenever they have profit after taxes (and interest). The minimum annual declaration of the dividend should be 35% of the net profit and not exceeding 70%. The

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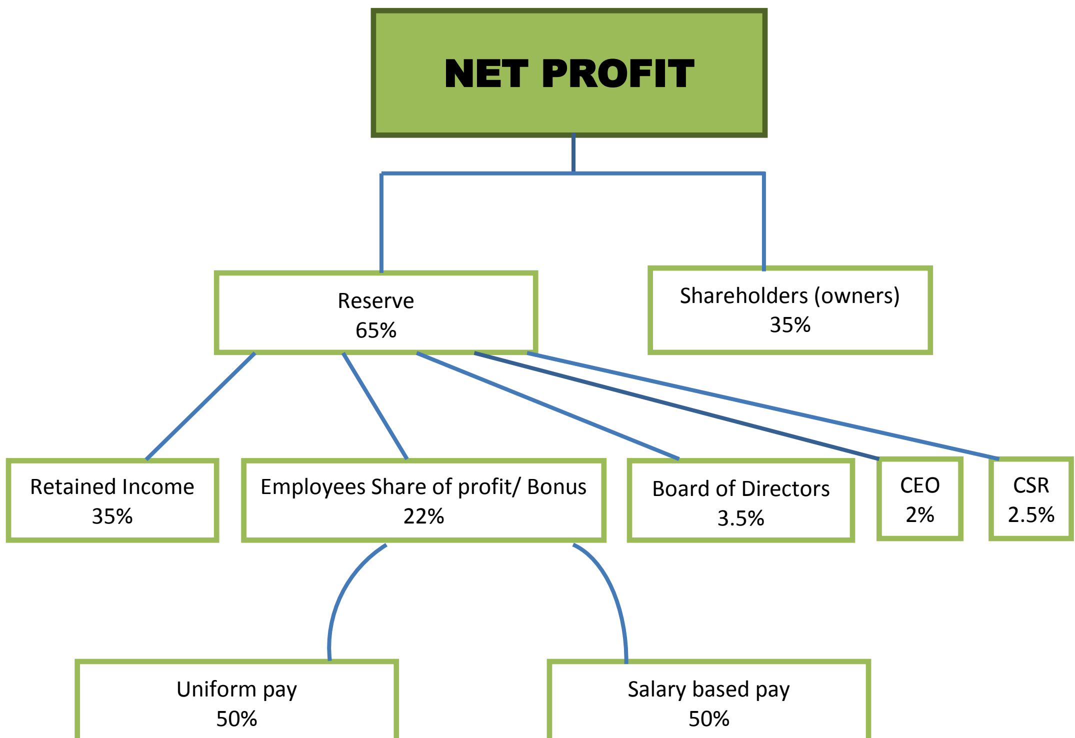
(1) The Telegraph, May 10 2011.
(2) Msnbc.com, 2/4/2009.
(3) The Guardian, 13 June 2012.
(4) ibid.
(5) A suggestion for medium size firms.
(6) Marjaana Helminen (2010), The International Tax Law Concept of Dividend, P. 97.

rest can be used as retained income, bonus, CSR, etc. The following should be an ideal distribution of the net profit. Dividend =35%, Retain =35%, employees (top to bottom) = 22%, Board of Directors = 3.5%, CEO = 2%, and CSR (corporate Social Responsibility) = 2.5%. In this proposal, if the CEO's compensation is moderate and linked to profit, then he has his share of 2% + share in the Board of Directors and + Share with employees. Of the 22% share in profit reserved for employees, 50% of it should be distributed equally among employees and the remaining 50% should be salary based. A chart below explains the distribution.



To simplify, an example is given:

Shareholders decide that the full time receptionist which is lowest level in hierarchy of the company 'KA Technology' would be receiving annual remuneration of $ 36,000. Hence the maximum the CEO can receive as his compensation is $ 432,000 (12 times the lowest Pay). If KA Technology is to make a net Profit after paying interest and taxes is $ 5 million, then in the following manner the Net profit would be distributed:

Table (1). Profit Distribution

Profit	Dividend	Retain	Employees		Board of Directors	CEO	CSR
	35 %	35%	22%		3.5%	2%	2.5%
$ 5,000,000	$ 1,750,000	$ 1,750,000	$ 1,100,000		$ 175,000	$ 100,000	$ 125,000
			(uniform) 50%	(salary Based) 50%			
			$ 550,000	$ 550,000			

KA Technology has 23 employees including the CEO and has 7 Board of directors (including the CEO). In the following manner the employees' share to net profit would be calculated. Receptionist, basic salary is $36000 as given in table 2, as recommended above that 50% of the 22% share of employee in profit to be distributed uniformly to every employee, hence, the receptionist and the CEO would receive the same amount of $23,913.04. The other 50% of the shares would be salary based/linked; here the receptionist would receive $10,153.85 as his/her share while the CEO would receive $121,846.20 as his share of profit. In Table 3 comparison of the pay between the CEO and the Receptionist is given. The annual salary of the receptionist is $36,000 but due to sharing mechanism s/he receives $70,066.88 almost double of annual basic Pay. This mechanism entitles employees to receive more pay if the net profit is higher.

Table (2). Salary based employee share in Profit (50% of 22% employees share)

Employees		pay scale/month	Annual Pay	percentage share	Employees
Receptionist	1	3,000	36,000	0.018461538	10,153.85
Programmers	15	5,000	900,000[1]	0.030769231[2]	16,923.08[3]
Design Supervisor	1	7,000	84,000	0.043076923	23,692.31
Program supervisor	1	7,500	90,000	0.046153846	25,384.62
Network Engineer	1	8,000	96,000	0.049230769	27,076.92
Media Manager	1	8,500	102,000	0.052307692	28,769.23
HR Manager	1	8,500	102,000	0.052307692	28,769.23
Marketing Manager	1	9,000	108,000	0.055384615	30,461.54
Founding CEO	1	36,000	432,000	0.221538462	121,846.2
Total Employees	23	Total Cost to Firm (Annual)	$ 1,950,000	Additional Cash benefit to employees	**$ 550,000**

Table (3). Comparative annual pay

	CEO	Receptionist
Basic pay	432,000	36,000
Uniform share	23,913.04	23,913.04
Salary based share	121,846.15	10,153.84
CEO Share	100,000	--------
BOD[4] Share	25,000[5]	--------
Total Pay	702,759.19	70,066.88

(1) Annual pay of individual programmer is 5000x12= 60,000 and for 15 programmer it would be 60,000x15=900000.
(2) Annual Salary based percentage of each programmer.
(3) Annual Salary based share of employee on profit per programmer.
(4) Board of Director.
(5) 175,000/7=25,000 for each member of the board.

Make distribution of dividend legally binding

Making dividend distribution legally binding in case of profit, would have multifaceted positive effect. First and foremost the protection of minority shareholders, secondly it would encourage more long-term shareholders and finally less stock market volatility. Ultimately it would be empowering the normal citizens with cash in hand to spend or invest, which is again good for economy.

Expected outcome

The shareholder is a member of public; the proposed regular dividend empowers him/her financially. It would limit volatility of stock markets and embolden the shareholder to hold on to their stocks longer. Ultimately if people are educated about stock markets it would be another way to make extra money without speculating for the general public.

Conclusion

Shareholders who are the actual owners of the firm must be empowered to approve issues which could affect their future returns (dividend). This paper proposes that shareholders must be empowered to approve or disapprove the loan. This paper also proposes a minimum of 35% of the net profit must be declared as a cash dividend by the profit making firm, in fact this paper is proposing it to become legally binding on the firms. Employees, being important member of the firm must have a claim on the profit. The CEO's remuneration should also be linked to profit performance and hence the pay must not be exorbitant. The shareholders must decide the lowest acceptable pay for its employees and maximum should not exceed 12 times the lowest pay (proposed for Small & Medium industry). All employees are bound to benefit from such a profit sharing mechanism; the better the financial performance the better would be their return.