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Performance bonus spat may be just the tip of an iceberg

The Lian Beng case raises many issues relating to executive remuneration and corporate governance challenges in family-controlled and family-run firms. BY MAK YUEN TEEN

Between FY2013 and FY2014, the total remuneration of the chairman and MD (above) moved from the S$2.75-3 million band to the S$5.25-5.5 million band, while those for the other two EDs moved from the S$1.5-1.75 million and S$1-1.25 million bands to the S$2.75-3 million and S$2-2.25 million bands respectively. PHOTO: ARTHUR LEE CH

ON July 10, the two independent directors (IDs) of Lian Beng – Sitoh Yih Pin and Wan Soon Bee – resigned, citing "differences in opinion from the management over certain company affairs". Both had been on the board since the company's initial public offering in 1999.

The Singapore Exchange (SGX) queried Lian Beng twice following the resignation announcements. The company's first response on July 14 disclosed that the differences in opinion were about the computation of the performance bonus of the three executive directors (EDs) – the chairman and managing director (MD), Ong Pang Aik, and his siblings, Ong Lay Huan and Ong Lay Koon.

According to the company, service agreements signed with the EDs since the company's listing in 1999 stipulated that the performance bonus is based on "net profits of the group before tax and before extraordinary items as reflected in the audited accounts of the group". This has been interpreted as group net profit before tax and before minority interest over the years.

The two IDs had felt that the performance bonus for the financial year ended May 31, 2014 should instead be based on group net profit before tax and after minority interest. They also wanted the re-computation of all past performance bonuses of the EDs since the company was listed on the same basis.

On July 16, the company responded to four further questions from SGX and disclosed that if the performance bonus for all the three executive directors had been based on "after minority interest", it would have been S$64,000 and S$2.025 million lower for FY2013 and FY2014 respectively.

The two IDs presumably became concerned with the performance bonus computation because of the big increase in the remuneration of the EDs between FY2013 and FY2014. Over those two years, the total remuneration of the chairman and MD moved from the S$2.75-3 million band to the S$5.25-5.5 million band, while those for the other two EDs moved from the S$1.5-1.75 million and S$1-1.25 million bands to the S$2.75-3 million and S$2-2.25 million bands respectively. The total remuneration for the three EDs increased from S$5.4 million to just under S$10 million.

The company's financial statements over the years show that "minority interest" became significant in FY2014, when it was S$39.9 million in the income statement, or about 28 per cent of net profit before tax.

BEFORE OR AFTER MINORITY INTEREST?

I can understand why minority interest has not been taken into account in computing the performance bonus, since this item appears below the net profit before tax item in the income statement and the service agreements were silent on it. Not surprisingly, the outsourced internal auditor, RSM Ethos, and the external auditor, Ernst & Young, both supported this interpretation, according to the company.

However, in principle, I agree with the IDs that the profit number used to calculate the performance bonus should take into account minority interest because the EDs should be rewarded for profits attributable to shareholders of the group and not to minority interests outside of the group. In fact, I would argue that it should be after-tax profit, rather than before-tax profit, as you would expect the EDs to consider corporate tax implications when they make decisions. After all, we are not talking about divisional or subsidiary executives, but the top executives of the group.

The original service agreement for the MD included the term "extraordinary items". Clearly, this is outdated because extraordinary items no longer appear in today's income statements and the concept of "comprehensive income" has now been introduced. If the terms used in service agreements are not reviewed and updated to reflect changes in accounting standards, disagreements over interpretation may arise.

One lesson from this episode is the importance of having clear definitions in service agreements, employment contracts and bonus plans, and to review them periodically and update them if necessary. It is too late to debate the interpretation of terms after agreements or contracts have been signed or after the performance period. To do so could be perceived to be a shifting of the "goalposts" and unfair to the executives.

However, there are bigger issues in Lian Beng.

SERVICE AGREEMENTS

The company said that computation of the performance bonus was in line with service agreements signed with the EDs since 1999, when it was listed. However, the company's IPO prospectus disclosed that service agreements had been signed only with Mr Ong Pang Aik and Tan Swee Hong. Mr Ong was then MD (and his father was the chairman), while Mr Tan was general manager. There was no mention of service agreements with the other two EDs.

Mr Ong's service agreement stipulated "an annual bonus of three months' salary and a performance bonus amounting to 1.5 per cent of the net profits of the group before tax and before extraordinary items as reflected in the audited accounts of the group". For Mr Tan, who is not related to the Ong family, his performance bonus was discretionary and is "based on the performance of the group and his own performance and subject to the approval of the board of directors".

Lian Beng entered into service agreements with the other two current EDs only in FY2009, based on disclosures in the company's annual reports. In other words, although the company's response to SGX's query mentioned that the computation of the performance bonus was in line with service agreements signed with the EDs since 1999, there were no service agreements in existence for these two EDs until FY2009.

The problem with service agreements at the time of an IPO is that they are typically put in place before a remuneration committee (RC) has been established. The IDs usually have no input into these agreements at the IPO stage. It is therefore important that these service agreements are for a limited period and subject to review by the RC after the IPO.

Lian Beng's annual reports disclosed that service agreements with the EDs are valid for an initial three-year period and subject to automatic renewal every three years. How involved was the RC in reviewing these agreements, including how the performance bonus was to be calculated, when these agreements were put in place or renewed? Did the RC seek any independent advice from suitably qualified experts, especially given that neither of the IDs appears to have technical expertise in such matters?

Service agreements and employment contracts should also not embed totally formulaic approaches for the award of bonuses and other incentives, with no discretion available to the remuneration committee.

BONUS AND PROFIT-SHARING PERCENTAGE

According to the initial service agreement for Mr Ong, he was entitled to an annual bonus of three months' salary and a performance bonus based on a profit sharing percentage of 1.5 per cent – there was no mention of any other bonus component. The company disclosed four components of remuneration in percentage terms in its annual reports – salary and CPF, bonus and profit sharing, other benefits and allowances, and directors' fees. If the "bonus" in the annual reports refers to the annual bonus of three months' salary, one may question why the EDs should continue to be paid a fixed bonus until today, which makes it effectively a part of the basic salary rather than being "performance-related".

Using the band disclosures of remuneration for the three EDs in the annual reports, I estimated that Mr Ong Pang Aik's bonus and profit share was actually between 4.2 and 4.5 per cent of net profit before tax since FY2009. For Ms Ong Lay Huan, it was between 2.1 and 2.4 per cent and for Ms Ong Lay Koon, between 1.5 and 1.8 per cent.

The bonus and profit-sharing percentage for the three EDs has skyrocketed over the years. In FY2006, it made up 18 per cent of the MD's total remuneration. It was 86 per cent in FY2014, which was 8.6 times his base salary. For the other two EDs, it increased from 15 per cent in FY2006 to 80 per cent or more in FY2014.

Of course, a major reason for the increase in the bonus and profit-sharing percentage is the strong financial performance of Lian Beng. Nevertheless, there is the question of whether the bases for the bonus and profit sharing were periodically reviewed by the RC to ensure that they are appropriate and are well aligned with the long-term interest of the company and its shareholders.

PERFORMANCE MEASURES

It appears that the performance bonus is based solely or largely on profit sharing. If profit measures are to be used for determining performance bonuses, measures that relate profit to the level of investment are more appropriate – such as return on equity. It may also be useful to incorporate a shareholder return measure. Non-financial measures of performance should also be considered.

One of the EDs, Ms Ong Lay Koon, is the head of finance and human resources. I think it is especially inappropriate to pay bonuses largely on a profit-sharing basis to someone holding such roles.

BOARD GOVERNANCE AND OWNERSHIP

According to the terms of reference of the RC, it has the following responsibilities:

- recommending to the board the framework of remuneration policies for directors and senior management;
- reviewing and approving specific remuneration packages for each director and the chairman, including director's fees, salaries, allowances, bonuses, options and benefits-in-kind; and
- reviewing the remuneration of senior management.

The RC's recommendations are submitted for endorsement by the entire board.

Lian Beng's board has a majority of EDs, with three EDs and two IDs, including an MD who is also the chairman. Any decisions requiring board approval or endorsement will be difficult to implement if the EDs do not agree. Clearly, the EDs are conflicted in approving remuneration policies that apply to them. In Lian Beng's case, there are also several other family members who are key executives and who are affected by remuneration policies approved by the board. It is difficult to see how this is different from interested persons approving their own interested person transactions.

In addition, Ms Ong Lay Koon is a member of the RC – and also of the audit and nominating committees. Remarkably, the board, including the IDs, seems to have been perfectly happy with this state of affairs, which in the case of the audit and remuneration committees are not in line with the Code of Corporate Governance.

In Lian Beng's case, where the chairman is also the MD, it should in due course have at least half the board being made up of IDs under the 2012 Code. However, even if it adds a third ID to comply with the Code, it will make no difference if the chairman has a casting vote in board decision-making, which is not uncommon.

Not only do the three Ong siblings make up a majority of the board, Ong family members own more than 30 per cent of the total shares of Lian Beng. This gives them considerable influence, if not outright control, over the appointment and removal of IDs. Therefore, if they are dissatisfied with the actions of the IDs, they could quite easily remove the IDs.

The Lian Beng case raises many issues relating to executive remuneration and corporate governance challenges in family-controlled and family-run companies. The spat over how the performance bonus should be calculated may be just the tip of the iceberg of the issues surrounding the company.

■ The writer is an associate professor of accounting in the NUS Business School where he teaches corporate governance and ethics. His 2007 report for the Monetary Authority of Singapore and SGX on improving the implementation of corporate governance practices includes a discussion of issues relating to service agreements, short-term incentives and profit-sharing plans for companies going public

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