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Lessons from Lian Beng for Remuneration Committees

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As an independent director (ID) and member of the remuneration committee (RC), what would you do if you had "differences in opinion from the management over certain company affairs" relating to how management should be compensated?

For two IDs at Lian Beng Group Ltd, a building construction and civil engineering company listed on the SGX, their course of action was to resign in mid-2015. Both had been members of the board since the company's IPO in 1999, so the decision could not have been made lightly.

In a nutshell, the differences in opinion centred on how the performance bonuses of the chairman and managing director, and the two other executive directors (EDs) – who are also the chairman's siblings – should be computed.

Lian Beng's position was that the pre-existing service agreements for the chairman and the EDs expressly based their performance bonuses on "net profits of the group before tax and before extraordinary items". Over the years, this had, in practice, been interpreted as "net profit before tax and before minority interest", even though the agreement was silent on the treatment of minority interest.

The company's perspective was understandable, since (a) minority interest falls below the net profit before tax line in statements of accounts; (b) the service agreements were not explicit one way or the other on the point of minority interest; and (c) its approach to determining performance bonuses has historically and consistently been "before minority interest".

The two IDs, however, took the view that, for the financial year ended 31 May 2014 (FY2014), the performance bonuses for the chairman and EDs should have been based on group net profit before tax and after minority interest.

In response to a query from the SGX, Lian Beng disclosed that the performance bonus for the three EDs in FY2014 would have been approximately S$2 million lower had it been computed "after minority interest".

The IDs' position that the performance bonus measure should have accounted for minority interests is not unusual. Generally speaking, if minority interests are significant, an "after minority interest" measure is seen to be better aligned with shareholders' interest.

PROFIT TEST

For many companies, the amounts involved are small and using a "before minority interest" measure has no significant impact on profit before tax calculations. This was the case for Lian Beng for many years. The difference for Lian Beng in FY2014 was that the minority interest component grew to nearly S$40 million, or around 28 per cent of net profit before tax. This was probably not foreseen at the time the bonus measures were first crafted in the service agreements of the three EDs.

The incident highlights the need for RCs to carefully consider a number of factors when defining "profit" as a basis for determining management bonuses. The relevant profit test can be based on one or more of the following:

- Before or after tax;
- Before or after minority interest;
- Before or after accrual of bonus expense;
- Before or after revaluation of gains or losses;
- Before or after foreign exchange gains or losses.

For each of these factors, the RC needs to consider management's ability to influence results and ensure that remuneration is properly aligned with the company's performance and shareholders' interest. As an example, foreign exchange volatility is dependent on macroeconomic factors that are beyond management control and thus such gains or losses would tend to be excluded. However, if management is expected to manage currency exposure, including deploying appropriate hedging strategies, then this item should be taken into consideration in determining bonuses.

A more significant factor is the revaluation of gains or losses which can be sizeable, and include a high level of subjective input from management. As such, there are considerable risks in including such items in bonus determination. Regardless of the measures used, the RC should test potential outcomes and calibrate rewards accordingly.

It is common for service agreements to be in place at the time of an IPO. However, businesses and strategies do change over time. An RC needs to regularly evaluate and confirm that performance rewards continue to be appropriate for evolving businesses. Thus, it is important for service agreements to be time bound, and subject to subsequent review by the RC.

Lian Beng's own annual reports indicate that its service agreements are valid for three years and subject to automatic renewal every three years. Best practices would suggest that RCs review incentive plans regularly and update them to ensure alignment with market conditions and business objectives.

ROOM FOR DISCRETION

Furthermore, where RCs lack technical expertise in compensation matters, it is advisable to engage subject matter experts who can provide independent advice.

Finally, while service agreements should be clear on performance measures and incentive structures, they should not be so formulaic as to leave no room for the RC to exercise discretion. ■