GRG Remuneration Insight 119

A Question of Independence

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Introduction

Hot on the heels of the Hayne Financial Services Royal Commission, a new parliamentary inquiry has been triggered by revelations regarding the various relationships between National Australia Bank and its auditor, EY. The focus of the inquiry is the question of how independent services can be provided when there is so much money on the line across a broad range of services, not all of which are subject to a standard of independence. In this Insight, GRG explores what it means to be independent, and reflects on what it means for our own services and clients.

What Does it Really Mean?

Given the subjective nature of the concept of independence, we have turned to the APES 110 Code of Ethics for Professional Accountants, which defines independence in two ways:

(a) Independence of mind – the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional scepticism.

(b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a Firm's, or a member of the Audit or Assurance Team's, integrity, objectivity or professional scepticism has been compromised." (Accounting Professional & Ethical Standards Board Limited ("APESB") 2010)

Most reasonable people have an expectation that this definition of independence holds true when advisory or assurance (including audit) work is described as independent; an expectation is created that there is no other relationship or connection that could compromise the validity and reliability of the advice or assurance. This is important as independence gives authenticity to professional services that are relied upon by a wide range of stakeholders. It is intended to safeguard key decision makers, investors, regulators and other stakeholders from a wide range of risks; with fraud, manipulation and collusion of the sort that triggered the last global financial crisis at one end, through to negligence, underperformance or inappropriate rewards at the other end of the spectrum.

A perceived lack of independence of remuneration advice may receive additional scrutiny, with the potential to result in a "strike" against the remuneration report at the AGM. With record remuneration strikes in 2018, for those companies that have already obtained a strike, the threat of a "spill motion" has never been so high.

The Inquiry

The inquiry will focus on the conduct of audit firms and will look at audit quality and competition, with an apparent focus on KPMG, Deloitte, PWC and EY. It will ask the question as to how these firms, that offer multiple services to the one company, can be truly independent, and not have a conflict of interest by potential loss of work and revenue if the client is unhappy with audit outcomes.

Unfortunately, this isn't just a local issue. Comprehensive reform is currently underway in the UK, centred along the same narrative of issues being considered in the Australian inquiry. A report

titled "Reforming the Audit Industry" released in 2018 identified issues across the competitive audit landscape. With much of the research and analysis concentrated around the Big 4, the report identified and proposed 49 points of reform leading to a complete regulatory overall in the UK, including the scrapping of the Financial Reporting Council (FRC), and the creation of a new statutory body, named the Audit, Reporting and Governance Authority, tasked with ensuring audit independence.

The Independence of Auditors

In its current state, the Corporations Act (the Act) specifies that within either an audit firm or company, the individuals employed to conduct the audit must be independent. The scope of independence is subsequently defined via an independence test which needs to be satisfied. Failure to pass the independence test is a criminal offence in respect of the people employed to undertake the audit function, and it requires that they have no connection to the accounting and audit practice of the firm being audited.

Therefore, a firm or company recognised as an "independent" auditor can at the same time intertwine themselves with their client on multiple fronts; including investment, advisory, IT, tax and legal services, without risking a breach of this subsection. There is no requirement for an auditor to disclose what other contracts, or income, they have secured within an audit client; that is, unless they too are giving KMP remuneration recommendations as well. It's notable that the standard of independence and transparency applicable to External Remuneration Consultants (ERCs) does not apply to the audit function, which has a much broader impact for a wider range of stakeholders.

So, what is happening in Australia? Transparency Reports give the market insights into auditor quality and independence. KPMG, PWC, Deloitte and EY create and lodge their Australian Transparency Reports every year with ASIC, which they make available to the broader community on their company website. Prescribed information to be included in the auditor's Transparency Report is outlined in Schedule 7A Corporations Regulations (2001). As per item 7A210, the Audit company must disclose revenue relating to: "(i) audit of financial state ments conducted by the Transparency Reporting auditor; and (ii) other services provided by the Transparency Reporting auditor." "Other services" are generally classified as non-audit services, which can be anything other than audit work, including investment, risk management, executive remuneration, regulatory compliance, advisory, IT, tax and legal services.

The revenue figures in the adjacent table have been taken from the latest Transparency Reports of the Big 4 Accounting firms (2018).

	Revenue from Audit Services (Millions)	Revenue from Non - Audit services to Audit Clients (Millions)
EY	$375	Not Disclosed
PWC	$409	$218
KPMG	328	$131.20
Deloitte	$278	$117

When it comes to transparency, it is EY that seems to be the outlier. They do not disclose a breakdown of revenue generated from the sale of non-audit services to their audit clients. They do however disclose "*revenues from permitted non-audit services to entities that are audited by the statutory auditor or audit firm and revenue from non-audit services to other entities*" with total revenue disclosed for 2018 of 1.41 billion Australian dollars, effectively giving the bare essentials of disclosure while adding complexity. This alternative method gives little insight into the scope of revenue created by any ongoing relationships of their audit clients. It begs the questions, why does EY disclose and categorise their revenue figures differently from PWC, KPMG and Deloitte, and; does that type of disclosure work within the spirit of the regulation and full transparency, since Transparency Reports are focused on their Audit quality?

Whatever the reason behind EY's approach to disclosure, the above Transparency Report revenue figures tell a story of revenue dependence on the audit relationships to generate opportunities to sell additional non–audit services.

Company annual reports also generally disclose an overview of their audit partner relationship by disclosing non-audit services and auditor's remuneration, in the notes to the financial statements. What is of concern is there is little detail as to what the non-audit services are that are being used by audit clients. Categorisation of non-audit services is generally ambiguous, such as "other assurance, general taxation and advisory services", giving shareholders little in the way of understanding of what true effect

the auditing firms has in offering additional non-audit services and their potential to influence perceptions of or actual independence in different areas. There is no statement as to what function these general services relate to, or what effect they have on the independent audit process, keeping in mind that it is often these very statements that effectively drive executive variable remuneration and bonuses.

Standard Applicable to ERCs

The Corporation's Acts has an apparent intent of ensuring the independence of ERCs can be objectively assessed by external stakeholders. It requires ERCs and Boards to understand their obligations even before a KMP remuneration recommendation is given in respect of an ASX listed company and prevents executives from quietly obtaining KMP remuneration recommendations by requiring Board approval of any potential ERC, before a recommendation is received. Not to do so is an offence under the Act.

A "Remuneration Consultant" is defined under the Act as a person who is external from the company "who makes a remuneration recommendation under a contract" relating to key management personal. They are required under Sect 206L to confine their provision of remuneration recommendations to non-executive directors (NEDs) and, or remuneration committee members. Failure to comply is a criminal offence under the Act. This approach seems to make an assumption, which generally holds in our experience, that NEDs are themselves able to operate independently and to consider such recommendations objectively; even in relation to their own remuneration.

In addition, S206M of the Act requires the ERC to provide a declaration to ASX listed boards, which accompanies the recommendation, stating whether or not advice was given free from undue influence and failure to do so is also a criminal offence under the Act. While this does not require that the advice is independent, it does set an expectation, and requires transparency on the matter.

If a remuneration recommendation is given, ASX listed boards are also required to declare via a statement in the Remuneration Report, as part of the Annual Report, whether they are satisfied that the advice was free from undue influence from KMP roles that the advice relates to, and if so, why they are so satisfied. In addition to the declaration, further disclosure is required, including the amount paid to the consultant for the recommendation, as well as detail of any other services provided to the company by them (generally taken to be the firm, rather than the individual consultant). This is important, as this disclosure is the only way to obtain information pertaining to the scale of independence between a consultancy and their client.

So, What Exactly is a KMP Remuneration Recommendation?

A remuneration recommendation is defined by section 9B of the corporations Act; as "*a recommendation on how much the remuneration should be; and, or what elements the remuneration should have; for KMP*".

Furthermore, a KMP remuneration recommendation does not include legal advice on remuneration laws; accounting advice regarding remuneration recognition (seen as general accounting advice), the provision of "facts" (the "data only" carve out) or general remuneration information applicable to all employees.

It is interesting to note that, anecdotally, many clients have received KMP remuneration advice from audit firms, however such advice has been constructed to avoid classification as a "recommendation" under the Act (which is easily achieved by careful wording), so that the other fees and services provided do not need to be publicly disclosed. Given that the Big 4 auditors include firms that are prominent providers of KMP remuneration recommendations to the ASX100, this may become a subject of particular interest to the upcoming Inquiry.

Who is Double-Dipping in Audit and KMP Remuneration Services?

GRG undertook research to uncover the extent of Audit firms also providing KMP Remuneration Recommendations. Disclosures within remuneration reports of all listed companies with a market capitalisation above $25 million, were the sample for the analysis. It revealed that over the last three years, there have been 51 instances where an audit firm also provided KMP remuneration recommendations and the results are summarised in the following table; however, this is likely to be an underestimate which does not capture many of the cases of auditors providing advice or information that in their supposedly independent judgement did not qualify as a recommendation. There is likely to be significant pressure on this judgement since a decision that it was a recommendation would require all fees for all services to be disclosed; presumably an undesirable outcome for such multi-service audit

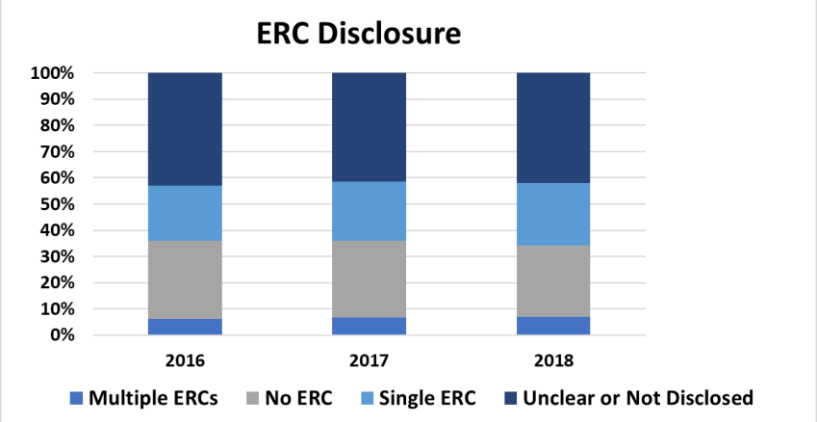
firms. However, in some cases although not classified as a recommendation, provision of KMP remuneration information or data was voluntarily disclosed, which has also been captured here.

	2016		2017		2018		Total	
	No.	%	No.	%	No.	%	No.	%
EY	7	47%	6	35%	8	42%	21	41%
PwC	5	33%	3	18%	3	16%	11	22%
BDO			4	24%	5	26%	9	18%
KPMG	3	20%	3	18%	2	11%	8	16%
Grant Thornton			1	6%			1	2%
HLB Mann Judd					1	5%	1	2%
Grand Total	15	100%	17	100%	19	100%	51	100%

EY, PWC, BDO and KPMG have been the most prevalent double-dippers from what is disclosed in annual reports, with 95% of all instances. Out of these four, EY is by far the biggest double dipper with 41%; Nearly double PWC, which came in second.

How Big an Issue is this?

Disclosure of the receipt of independent KMP remuneration recommendations is important as it gives shareholders assurance that good governance and objectivity are being applied. To examine the scope of the issue, we considered the sample of 694 listed companies with market capitalisation above $25 million between 2016 and 2018 and found that the use of ERC's for KMP remuneration recommendations increased slightly over the last three years, growing from 27% of companies to 31%.



On average 29% of companies disclosed that they did not use the services of an ERC each year, or more precisely, that they did not receive advice or information that was classified as a recommendation. 63% of that group have apparently received no external inputs or independent recommendations over a long period which might be of concern to some stakeholders. Also concerning is that on average 42% of companies have unclear, or a complete lack of, disclosure in their annual reports regarding KMP remuneration recommendations. 57% of the companies in the sample never disclosed a KMP remuneration recommendation service being received at any time over the 3 years.

This lack of disclosure could be an indicator of a lack of independence, since it would seem unlikely that the Board has not considered the appropriateness of KMP remuneration for such a long period. It begs the questions as to what other resources these companies have used to evaluate and set KMP remuneration. If non-ERC resources have been used, then did those resources come from their auditor?

Conclusion

Given the large number of companies deciding to not disclose KMP remuneration decision-making inputs, it is difficult to establish the true level of influence audit companies have on KMP remuneration. With KMP remuneration subject to constant public and shareholder scrutiny, there is an opportunity for listed companies to get ahead of the issue by adopting a robust transparent remuneration governance framework that ensures that not only independent advice, but also independent data, is being considered.

The findings of the parliamentary inquiry are due to be released by March 2020 and are expected to lead to substantial regulatory changes. In the UK, the proposed reforms resulting from a similar inquiry include a requirement for the Big 4 to undertake a legal separation between their audit, and non-audit business units and heavier penalties including making the offering of non-audit services to large companies by their statutory auditor a criminal offence. GRG can assist companies to avoid many of these issues by providing truly independent ERC services founded on Australia's largest and highest quality KMP remuneration database.