Society of Corporate Law Academics (SCoLA)

31 August 2023

Committee Secretary
Parliamentary Joint Committee on Corporations & Financial Services
Parliament House, Canberra
By email: corporations.joint@aph.gov.au

Dear Secretary

Ethics and Professional Accountability: Structural Challenges in the Audit, Assurance and Consultancy Industry

The Society of Corporate Law Academics (SCoLA) welcomes the opportunity to engage with the Committee's Inquiry into Ethics and Professional Accountability: Structural Challenges in the Audit, Assurance and Consultancy Industry.

SCoLA is the peak body for corporate law academics in Australia, New Zealand and across the Asia Pacific rim. The Association has over 100 members and has a role in fostering debate and discussion about corporate law reform, including matters related to audit, assurance and consultancy.

SCoLA has an executive committee that includes academics from across Australia and New Zealand. The Executive has expertise within its membership on matters relevant to aspects of the Committee's current Inquiry. Associate Professors Michael Duffy, Monash University, and Natania Locke, Swinburne University, have expertise in accounting firm conflicts and in professional service firm cultures and conflicts, respectively. Associate Professor Duffy has provided comments on conflicts issues, and Associate Professor Locke has prepared a consideration of cultural issues and contributed comments on conflicts. These are combined in the attached document.

If the Committee has any queries in relation to matters raised in the attached material we would be happy to facilitate direct connection with the authors.

Yours faithfully

V Brand

Vivienne Brand

SCoLA President

1. Introduction

Our comments reflect recent research on the link between so-called 'masculinity contest cultures' on organisations and a propensity to engage in illegal or unethical behaviour.[1] Natania Locke and Helen Bird have been exploring whether this link is prevalent in recent Australian examples of corporate governance failures.[2] For present purposes, we adopt the meaning of 'governance' as used by Commissioner Hayne, in the 2019 *Final Report of the Royal Commission into Misconduct in the Banking, Finance and Superannuation Industry,* as referencing the entirety of structures and processes by which an entity is run.[3] Our conclusion is that there is a clear correlation between the presence of these cultures in organisations and failures in internal governance. It is likely that the presence of these cultures is also a cause of such failures.

2. The business of advisory and consulting firms

Advisory and consulting firms make their money from the scarce expertise of its staff. Their business model relies on the client not being able to afford the ongoing employment of staff with this expertise. This could be because of the high rates of fees that such expertise may be worth in the market, or because the need for the expertise is short-lived and project focussed.

The fact is that these firms now house much of the expertise in many different areas that would otherwise be available to clients. This scarcity of human resources is prevalent in both the public and private sector.

These firms build on existing expertise by learning from projects and advice delivered at previous clients. They would argue that this experience is their intellectual property and that they may employ it as they please. Regardless of whether the context of their client is the public or private sector, confidentiality of client information always plays a role in some form.

Internal policies and processes will be in place at these firms to try and guard against the misuse of such information. However, legal and compliance functions in organisations are only as effective as they are allowed to be through the support of senior leadership. This support may be lacking, owing to what social scientists have termed 'masculinity contest cultures'.

3. The meaning of 'masculinity contest cultures'

The studies cited above reveal an important connection between shareholder-centric approaches to corporate governance, the focus on short-term corporate objectives, and bonus reward systems that has resulted in 'masculinity contests' inside corporations. These contests reward 'winning', which is translated into who makes the most profit, rather than rule compliance.[4]

[1] June Carbone, Naomi Cahn and Nancy Levit, 'Women, Rule-Breaking, and the Triple Bind' (2019) 87 *George Washington Law Review* 1105; Jennifer L Berdahl et al, 'Work as a Masculinity Contest' (2018) 74(3) *Journal of Social Issues* 422.

[2] Natania Locke and Helen Bird, 'Rule-breaking and Bloke Governance: The Role of Masculinity Contest Cultures in Australia's 2020 Corporate Governance Scandals' (Paper Delivered at the Corporate Law Teachers' Association Annual Conference 2021, University of Sydney, 7-9 February 2021).

[3] Commonwealth of Australia, *Final Report: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Volume 1* (2019) 334.

[4] See (n 1).

While the mentioned studies focus on corporations, the presence of this problematic culture is not restricted to specific business forms. It may be present in any complex organisation that follows a hierarchical governance structure. Within this context, it may be said that organisations where this culture is present value short-term gain above all else and set performance expectations in line with this objective. They reward the achievement of performance goals with handsome remuneration and the failure to achieve the goals with dire consequences, mostly in the form of redundancy or the loss of bonuses. At the same time, a culture develops where the means by which the goals are achieved are not questioned. Individuals who are willing to turn a blind eye to legal or ethical rule-breaking are promoted, and those who object against such behaviour are viewed with suspicion.

Berdahl et al identify four correlated dimensions that repeatedly appear from studies of organisations that evidence such a culture:

> *Show no weakness* prescribes a swaggering confidence that admits no doubt, worries, confusion or mistakes, as well as suppressing any tender, feminine emotions ("no sissy stuff"). *Strength and stamina* associates achieving workplace respect and status with being the "sturdy oak": physically strong and athletic, with endurance and stamina (e.g., ability to work long hours without breaks), even in occupations that involve mental rather than physical labor. *Put work first* aligns with becoming a "big wheel" by brooking no interference with work from any outside or personal sources, such as family obligations, not taking any breaks or leaves (seen as signs of weakness). *Dog-eat-dog* characterizes the workplace as a hypercompetitive or gladiatorial arena where winners dominate and exploit the losers; rivals must be crushed ("give 'em hell") because others cannot be trusted.[5]

Several cultural characteristics may be identified with Berdahl et al's model. A tolerance of 'rule-breaking' to outperform one's peers is often an integral part of this culture. This rule breaking may take the form of illegality, but may also be less than illegal and take the form of unethical or harsh conduct. The masculinity contest mindset dismisses or trivialises compliance with codes of conduct, ethical practices, internal institutional controls as well as respect for

customers, teamwork, and restraints on the use of devious or manipulative behaviour. It does so on the basis that the rule-breaker can simultaneously 'get away with it' and in the process elevate their own stature within the organisation. Rule-breaking of this kind pays off when it produces large short-term gains and the risk of being made to disgorge those gains is considered small.

4. Evidence that such cultures could be present at advisory and consulting firms

We have reviewed the report from Senate *PWC: A Calculated Breach of Trust.*[6] The application of a 'masculinity contest' lens may assist in understanding the culture in PWC, at least in the division on which the report focused.

The rule-breaking in this instance is clearly set out in the report. It takes the form of both illegality and unethical behaviour. The current CEO of PWC has publicly admitted that they had failed to keep those leading their tax business to account.[7] It is clear from the report that Senate has access to emails that show that senior leadership at PWC were aware of these

[5] Berdahl et al (n 1) 433.
[6] Senate, Finance and Public Administration References Committee, *PWC: A Calculated Breach of Trust* (June 2023).
[7] Ibid 11 [1.60].

breaches of confidentiality for years without any action taken against the individuals involved.[8] It is the publication of the breaches that would be problematic for the organisation, not the breaches themselves.[9]

It is interesting that the former CEO of PWC's first public comment after the allegations first made headlines was that this is a 'perception issue'.[10] This is in line with the 'show no weakness' dimension of masculinity contest culture. This dimension is further supported by the reluctance to disclose breaches to the Tax Practitioner's Board,[11] and their reversal of the decision to disseminate the preliminary findings of the internal review into culture.[12] Also note the careful indication in the public statement by the current CEO that the culture was limited to the tax division.[13]

The report alludes to the failure of the duty of care by PWC towards the rest of its staff in not being forthcoming about the identity of those involved in the breaches.[14] This may point towards the 'dog-eats-dog' dimension of masculinity contest cultures. It could evidence a lack of concern for colleagues. It would be worthwhile to investigate if this carries further into competition between divisions of the firm and between individual partners of the firm.

The report shows that PWC misused reliance on legal professional privilege to cover its

wrongdoing and that this must have been condoned at the highest levels of the organisation.[15] When the presence of masculinity contest cultures is overlaid with this finding, a possible reason for this attitude emerges: Those in leadership were the best at rule-breaking in the past. They have a vested interest in safeguarding their positions by thwarting scrutiny.

The Committee is in a unique position to investigate whether the other dimensions of masculinity contest cultures are evident in the industry. Anecdotal evidence suggests that they are, with long working hours being the norm (*strength and stamina*), as well as an over representation of younger workers with less family responsibilities that could compete with a focus on work (*put work first*).

Note that furthering strengthening the ringfencing of operations is unlikely to succeed when this culture is present in an organisation.[16] This is because the competitive incentive systems at organisations like these may override the importance of internal controls that are put in place. Ringfencing only works when those at the top want it to work.

5. Partnership or corporations?

It is our opinion that the business form of the organisation is less important. Mandating incorporation will not fix any environment that has allowed rule-breaking to become commonplace. Theoretically, general partners ought to be more careful about wrongdoing, as

[8] Ibid 14 [1.75].
[9] Ibid.
[10] Ibid 8 [1.44].
[11] Ibid 7 [1.36], 14-15 [1.77]–[1.78].
[12] Ibid 9 [1.46].
[13] Ibid 11 [1.60].
[14] Ibid 18 [1.109].
[15] Ibid 15 [1.83].
[16] Ibid 11 [1.62].

they are jointly liable for claims against the firm.[17] This is equally so for general partners of incorporated partnerships, who are personally liable for any amounts that the firm is unable to satisfy.[18] The potential for personal liability is the reason why partnership remains a popular business form for the accounting and legal professions. There is a perception that the personal liability of partners would instil a heightened sense of propriety in dealing with the affairs of others.

As for criminal liability, the absence of legal personality for partnership means that partners bear criminal responsibility as individuals. Incorporated partnerships are body corporates,[19] which brings them under the ambit of Part 2.5 of the *Criminal Code Act 1995* (Cth).[20] This part provides that bodies corporate may be held liable for the offences under the *Code* in the same manner as individuals, with such modifications as necessary.[21] This expressly includes offences punishable by imprisonment.[22] If the fault element of a particular crime is intent, knowledge or recklessness, that fault element is attributed to the body corporate if it has 'expressly, tacitly or impliedly authorised or permitted the commission of the offence'.[23] Such authorisation or permission may be proven if:

> (c) … a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance with the relevant provision; or
>
> (d) … the body corporate failed to create and maintain a corporate culture that required compliance with the relevant provision.[24]

'Corporate culture' is defined to mean '… an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities takes [sic] place'.[25]

However, the approach to criminal liability of body corporate for federal and state crimes is not uniform. The state specific criminal legislation does not necessarily extend possible criminal liability to body corporates. For instance, the *Crimes Act 1958* (Vic) only extends liability to body corporates where they participate in the destruction of evidence.[26] Here too, a corporate culture that tolerates the crime leads to the attribution of fault to the body corporate.[27]

There may be an argument to be made that mandating that these firms to incorporate as companies would bring them under ASIC's supervision. However, bringing the consulting industry under ASIC's supervision is not per se a silver bullet. Such a move will need to be accompanied with enough resources to monitor and industry with very deep pockets and sophistication.

[17] See, for instance, *Partnership Act* 1958 (Vic) ss 13–16. Partnership is regulated by individual states and territories.
[18] Ibid s 96(5).
[19] Ibid s 84(10(a).
[20] ss 12.1–12.6.
[21] s 12.1(1).
[22] s 12.1(2).
[23] s 12.3(1).

[24] s 12.3(2).
[25] s 12.3(6).
[26] ss 253–255.
[27] ss 255(1)(c)(iii), 255(4)(c).

Others might argue that the governance structure of corporations, where management is overseen by an independent board of directors, would be preferable for these organisations. However, if a problematic culture exists in an organisation, the corporate form alone has not been able to counteract it. This is evident in many of the more recent corporate governance failures seen in Australia.

6. Auditor independence

6.1. Audit accounting firm conflicts of interest in the early 2000s

The issue of conflict of interest for auditors through the offering of non-audit services by those same firms was dealt with in some detail by Professor Ian Ramsay in 2001.[28] This issue had arisen following growth in the cross-selling of other forms of expertise by firms that started out as audit service providers. Conflicts could arise because an audit firm may be required to audit work that had been performed by that same firm. It can be imagined that there would be a significant disincentive for an auditor to criticize work that it had itself (through another arm) performed, particularly if that other work was lucrative to the firm.

A significant example in the early 2000s was the issue of audit firms that provided actuarial services to insurance companies yet, as auditors, were separately required, to a degree to review the reasonableness of assumptions such as reasonable reserving levels (higher levels of which would tend to reduce declared profits and share prices). Similar auditor independence issues had also arisen at this time in the USA following accounting scandals in relation to the auditing and collapse of Enron and WorldCom.

The Ramsay Report was followed by several legislative changes governing non-audit services and rotation of audit partners.[29]

6.2. Regulation of auditor independence

There is extensive regulation currently in place to ensure auditor independence.[30] These provisions mandate the notification of ASIC when conflicts of interest exist between the individual auditor or auditing firm and the audited body. They are drafted so that they would be binding regardless of the business form of the auditing firm.

Any director of an auditor company or member of an auditing firm, who is aware of the conflict

of interest and who does no ensure that ASIC is notified, also contravenes the Act.[31] A member of an auditing firm, or a director of an auditing company, contravenes this part if another member of the firm, or another director of the company, knew about the conflict and the firm or company did not notify ASIC.[32]

[28] Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform: Report to the Minister for Financial Services and Regulation* (October 2001) <https://treasury.gov.au/sites/default/files/2019-03/ramsay2.pdf>.

[29] See Larelle Chapple and Boyce Koh, 'Regulatory Responses to Auditor Independence Dilemmas: Who Takes the Stronger Line?' (2007) 21(1) *Australian Journal of Corporate Law* 1.

[30] *Corporations Act 2001* (Cth) ss 324CA–324CL.

[31] ss 324CB(1A), 324CC(1)

[32] ss 324CB(2), 324CC(2).

It is a possible defence to raise that the individual auditor, firm member, or director, had reasonable grounds to believe that the firm or company had a quality control system in place that could provide reasonable assurance of compliance with the general requirements for auditor independence.[33] However, members of auditing firms and directors of auditing companies still contravene these provisions if none of them were aware of the conflict of interest and would be so aware had a quality control system provided reasonable assurance.[34]
The Act provides ample direction about the meaning of 'conflict of interest'.[35]

Contravention of these provisions is an offence. The *Corporations Act* is Commonwealth legislation, which means that the provisions of the *Criminal Code* set out in paragraph 5 above apply here.

If the provisions for auditor independence are not adhered to, it is hard to imagine that more regulation would solve the problem. It is likely that those who stand to be held accountable for breaches of these provisions either expect the risk of being discovered, or the risk of being successfully prosecuted, is small and the reward for breach is large. Certainly, if firms and individuals were prosecuted for these breaches, this might have a deterrent effect on others in the industry.

Moreover, there may already be remedies in the common law where the conflict concerns the misuse of confidential information.

6.3. Civil remedies in contract law or equity

The recent controversy in Australia may appear to raise a slightly different conflict of interest

issue for the same accounting audit firms. The issue appears to be where they receive confidential information from one client and may use it to the benefit of another client, possibly to the detriment of the first client.

It can be commented that these types of conflict of interest issues are well developed in relation to the obligations of lawyers who, as fiduciaries, are required to avoid conflicts.[36] For lawyers, liability may be avoided in equity if the conflict is fully disclosed to the client and fully informed consent is obtained.[37] What might be required for a fully informed consent will depend on the circumstances,[38] but may extend to the need for independent legal or other advice to the client.[39] If lawyers do not obtain such consent, then they must avoid acting for the client. Whilst accounting audit firms may not owe fiduciary obligations to companies they audit or the shareholders of those companies,[40] that does not mean that such fiduciary duties might not possibly arise where they are not auditing but rather are providing legal or other advice to companies or government. There are several established fiduciary relationships and while

[33] ss 324CA(4)–(5), 324CB(6), 324CC(6),

[34] ss 324CB(4), 324CC(4).

[35] s 324CD.

[36] Law Council of Australia, *Australian Solicitors Conduct Rules* (24 August 2015) r 10 and 11, which set out how a practitioner must avoid conflicts of interest between two or more clients of the practitioner or of the practitioner's firm.

[37] Ibid r 11.3.2.

[38] *Maguire v Makaronis* (1997) 188 CLR 449, 466–7 (Brennan CJ, Gaudron J, McHugh J and Gummow J). See also *D P C Estates Pty Ltd v Grey & Consul Development Pty Ltd* [1974] 1 NSWLR 443; *Chan v Zacharia* (1984) 154 CLR 178.

[39] *Woods v Legal Ombudsman (Vic)* [2004] VSCA 247.

[40] *South Australia v Peat Marwick Mitchell & Co* (1997) 24 ACSR 231, 267-270.

courts are not always keen to expand these, the categories are not closed and it will often depend on the factual circumstances.[41] Further, there may be contractual obligations of confidence,[42] as well as obligations of confidence arising in equity,[43] that may provide actionable remedies for any government departments that can prove breach of such obligations and loss resulting therefrom.

It follows that civil remedies for government departments may already exist in this space.

For reasons stated, incorporation of accounting firms may not improve the situation. The main rationale of incorporation is to improve asset protection for owners rather than necessarily making them more accountable to clients or customers. The need for greater accountability through personal liability is indeed one of the reasons that professionals have (until recent times) been required to operate through partnerships rather than being allowed to incorporate.

The question of attempting to break up partnerships may possibly reduce such conflicts of interest (and also introduce more competition) but there may be some jurisdictional difficulties for an Australian government in seeking to impose such restructures on international partnerships.

7. Suggestions on culture

There are no quick and easy solutions to problematic cultures.

However, if the Committee finds that problematic cultures are prevalent in this industry, one place to start would be to investigate their remuneration and incentive structures. Behaviours that are rewarded are behaviours that will continue to thrive. It is important to consider not only monetary reward in the form of salary, incentive payments, and profit sharing, but also rewards in the form of promotion and access to more lucrative opportunities. The avoidance of negative consequences, such as potential redundancies in departments that under-perform, might be a form of reward in an organisation.

We have referred above to the Final Report of the Banking Royal Commission.[44] In chapter 6 of the report, Commissioner Hayne discussed the culture, governance and remuneration of the institutions subject to the inquiry. His findings may be summarised as follows and is illustrated in the figure below: The *objectives* of a corporation, or firm, determine its risks. '*Risks*' are those matters that stand in the way of meeting the objectives of the corporation or firm. Corporations and firms *value* those actions and behaviours that further the objectives of the corporation or firm. By implication, this includes all actions and behaviours that reduce the risk of not meeting the objectives. The corporation or firm *rewards* what it values. Culture is the culminating and consistent effort by those in control of the firm or corporation to govern, using the four points highlighted above.

[41] See generally R Meagher, D Heydon and M Leeming, *Equity Doctrines & Remedies* (LexisNexis, 4th ed, 2002) [5-005]-[5-020].

[42] Senate Finance and Public Administration References Committee, (n 6) [1.8].

[43] See e.g. Josh Needs, 'PwC Partners Held "No Regard for their Obligation to Confidentiality"' *Accountants Daily* (Online, 23 June 2023) <https://www.accountantsdaily.com.au/business/18694-pwc-partners-held-no-regard-for-their-obligation-to-confidentiality#:~:text=PwC%20partners%20held%20%E2%80%9Cno%20regard,A%20calculated%20breach%20of%20trust>. See generally Meagher, Heydon and Leeming, (n 41) [41-005]-[41-140]. [44] See n 3 above.

Figure 1: Culture explained - Final Report of the Banking Royal Commission

When the objective of a firm is to make profits at all costs, and the risk associated with sanction for breaches of compliance in the pursuit of such profit is low, compliance risk may be less relevant. It is no longer a risk and therefore not rewarded. If it is an intrinsic objective of a firm to be compliant with its legal and ethical obligations, monitoring and reducing the risks of non compliance will be rewarded in the firm. If this is consistently done, the culture should change as well.

We are aware the several firms have announced internal reviews of culture after the PWC matter, but as explained, but this may be insufficient if the prevalent culture counters internal endeavours to weed out rule-breaking behaviour.

External review of the culture within consulting and advisory firms may be advisable.