Submission by Professor Graeme Samuel AC in response to questions on notice from the Parliamentary Joint Committee on Corporations and Financial Services - 28 February 2024

Written questions on notice

Senator Deborah O'Neill, Chair of the Parliamentary Joint Committee on Corporations and Financial Services, has asked if you would respond to the following written questions on notice:

1. On pages 22 to 24 of its submission (Submission 50), Treasury set out principles for evaluating whether to intervene in the regulation of the audit, accounting and consulting industry. If you have had a chance to review that submission, could you discuss how the Treasury principles might be applied to your recommendations or suggestions?
2. On page 25 of its submission (Submission 50), Treasury suggested that the committee seek information on firm structure, partnership frameworks in theory and practice, firm governance processes, how firms operationalize their obligations, data on firm performance, and why the current regulatory environment is deficient. Are you able to provide any information on those points, potentially as a written response to Treasury's submission?

Documents to aid questions taken on notice at the hearing

At page 26 of *Hansard*, Senator O'Neill asked you take the following on notice:

> Could I ask you, if it would be possible for you, to look at the cultural section of that report? The report does indicate practices that would need to be the focus of attention by any regulator that were to oversee it, whether that was a structural change to corporate identity or to remain within the partnership structure, as you suggested; that might just be as useful. Could I ask you to have a look at the report in that way?

The Chair has asked that your attention be drawn in particular to the highlighted paragraphs in the **attached** page from that report for your comment.

The Chair also asked you to review evidence provided to the committee by Professor Elise Bant. Professor Bant's evidence is available using the following links:

- Submission 6;
- Supplementary Submission 6.1; and
- *Hansard* transcript of appearance on 6 October 2023 (see pages 42 to 48).

Response by Professor Graeme Samuel AC

I have chosen to respond to the issues raised above with a single supplementary submission, noting that my views on several matters being considered by the Committee have been addressed in my earlier submission and subsequent appearance before the Committee.

I have read the relevant parts of the Treasury submission. In particular Treasury provides a cost/benefit analysis of the various forms of regulation that might be applied to audit and consultancy services. There is nothing in that analysis that would cause me to modify my views on what is necessary or appropriate. The focus and objective of my proposed reforms is to bring about significant change to the regulatory oversight, ethics, and culture of consulting firms, without the need for extensive and detailed regulations.

It has been my experience (and confirmed by Kenneth Hayne KC in his Royal Commission Report) that detailed regulations lead to a tick-a-box approach, with a consequential search for avoidance techniques to take advantage of loopholes. Concepts of conflicts of interest, ethics, culture and professionalism are not satisfactorily able to be comprehensively defined by regulations that become subject to legal interpretation. My comments below under the heading of 'The culture of consultancy firms', will illustrate my preferred position.

Professor Bant's submissions provide what is undoubtedly a scholarly analysis. However, they seem to me to complicate an essentially simple proposition. Conflicts of interest must be avoided and cultural and ethical standards reflecting community expectations, must be mandated, overseen by ASIC and failures to maintain those standards should be subject to transparent exposure, regulatory discipline and the inevitable accountability in the market.

In my earlier submission and in my appearance before the Committee, I attempted to address four issues concerning consultants.

A. The need to engage consultants

My perception is that both the public service and private enterprises resort to the use of consultants far too often and inappropriately. My primary experience has been in the public service. I have detailed in my earlier submission the many reviews and inquiries in which I have been involved, in most cases as the lead or sole independent reviewer. While a consultant might be engaged for a discreet task - for example the conduct of a staff survey in the case of the APRA Capability Review - each of the reviews and inquiries in which I have been involved (including most recently, the Review of the Defence Trade Controls Act) have been satisfactorily conducted without the need to engage professional consulting firms. Each has been led by one, two or three individuals with long standing expertise.

The positive response in the public and political arena is a testament to the quality of the reviews and inquiries and the intellectual integrity of the public servants involved.

The public service is imbued with the ethic of providing frank and fearless advice with a clear focus on the public interest. The work ethic is reflective of a commitment to intellectual integrity.

In the private sector, it has been my observation that consultants are too often engaged to undertake reviews of business practices which should be within the remit and capability of the senior management of the organisations concerned. The resort to engaging consultants must raise questions as to the capability of senior management. If a board and CEO do not know what culture is needed to be imbued in their organisation, perhaps they should be considering their suitability for leadership of the organisation. Indeed, I wonder if those responsible for a delinquent culture of the past, can ever be effective in implementing change for the future.

B. The need for audit integrity.

Audits of corporations are a vital discipline that serves shareholders, creditors, and employees in providing important information as to a corporation's financial affairs. But, the discipline relies on the integrity of the audit and auditors.

ASIC has the power to oversee and regulate the integrity of audit services and auditors. That power resides in ASIC's power to register auditors (subject to whatever conditions it may consider appropriate to impose), to suspend or cancel registration as a consequence of audit processes and reports that fail an integrity test, and its examination of audit reports and disclosure of inadequate audits.

But that power needs to be exercised with rigour, so that auditors recognise that a failure to maintain intellectual integrity and high quality in the conduct of audits will have inevitable serious consequences. This is not to regard penalties as essential for the sake of effective regulation - rather it is a recognition that audits are a vital element in providing shareholders, creditors and employees an assurance as to the financial integrity of a business organisation.

ASIC has previously examined and opined on the quality of audit reports. That practice should be encouraged. But the results of ASIC's examination must be made public with clear identification of the reports concerned and the audit firms involved. Transparency is an unforgiving discipline and allows shareholders to impose accountability on delinquent auditors.

There is an inherent conflict of interest in a single firm supplying both audit and non-audit services to the same corporate organisation. This cannot be satisfactorily overcome by the application of 'Chinese walls'.

Proposals to require structural separation of audit services and non-audit services into separate organisations are draconian overreach, impractical and ineffective. They cannot properly be effected with Australian firms having global associations - the suggestion that Australia might 'lead the world' with a requirement of structural separation is unreal and a tacit acknowledgement that the proposal is impractical and ineffective.

But the conflict of interest in a single firm providing both audit and non-audit services to the same organisation must inevitably impact on the integrity of the vital audit service.

Accordingly, audit firms or their associated entities (Australian or international) should be prohibited from deriving income from non-audit services provided to the audited corporate organisation, including all associated entities both in Australia and internationally. This prohibition can be simply effected by ASIC in the conditions that it could impose on registration of auditors.

The financial impact of this prohibition should be minimal. It would simply result in the reallocation of non-audit services amongst consultancy firms.

C. The regulation of partnerships

There has long been a puzzling omission in the regulation of business organisations. While the activities of corporations and their directors are encompassed in detail in the Corporations law administered by ASIC, partnerships fall to be regulated under State and Territory law, administered by local agencies.

The partnership structure is an anachronism which, by reason of the Australian Constitution, excludes its members from Commonwealth regulation, in particular under the Corporations law.

That exclusion should be rectified by a reference of powers by States and Territories to the Commonwealth, in much the same way that corporations, previously regulated at State level, became subject to a single national corporations law.

It would seem appropriate for partnerships to be deemed to be corporations for the purposes of the corporations laws with appropriate application of those, with a distinction being drawn between small partnerships being treated as small private companies and larger partnerships being treated as public companies.

D. The culture of consultancy firms

It is not possible for the culture of an organisation to be satisfactorily set by regulation or regulators. The quality and integrity of audit services is addressed earlier in this submission. But the ethics and culture of consultancy firms providing non-audit services is equally important.

The culture and ethical standards of an organisation are set by its leaders. They need to impose on the organisation the culture that ensures that the earning of profits is achieved within boundaries of ethical conduct that meets evolving community expectations. Failure to achieve and maintain that ethical conduct should result in transparent accountability and resultant regulatory and market discipline.

Culture can be thought of as a system of shared values and norms that shape behaviours and mindsets within an institution. Once established, the culture can be difficult to shift. Desired cultural norms require constant reinforcement, both in words and in deeds.

Statements of values are important in setting expectations but their impact is sotto voce. How an institution encourages and rewards its staff, for instance, can speak more loudly in reflecting the attitudes and behaviours that it truly values.

Understanding an institution's culture can be challenging. Organisational culture is rarely homogeneous and can be opaque to external observers. Typically, an institution's culture will consist of many layers: some aspects will be common across the whole organisation whereas others will exist as 'sub-cultures' within individual teams, departments, and peer groups. Culture can also be viewed through various lenses – such as the customer culture, the innovative culture or the risk culture.

Royal Commissioner Kenneth Hayne KC conducted an extensive examination into issues of governance and culture within financial institutions.

His Report was preceded by the Report of the APRA Prudential Inquiry into the culture, governance and accountability of Commonwealth Bank of Australia.

Corporate Australia generally should study the governance and culture sections of both reports - they contain valuable insights and lessons for everyone responsible for the governance of our business organisations. The APRA CBA Report has been described by some as the bible for corporate governance.

Hayne summarised it nicely by outlining six very simple ideas that must inform business conduct:

- Obey the law.
- Do not mislead or deceive.
- Be fair.
- Provide services that are fit for purpose.
- Deliver services with reasonable care and skill.
- When acting for another, act in the best interests of that other..

Both Reports urge business to adopt the "*Should I do this* " test, rather than a *'Can I do this'* with its inherent ticking boxes approach. Layer on top of these principles the governance, culture and remuneration principles discussed in the CBA /APRA Report and you have the the foundations of a trustworthy financial services, indeed corporate, sector.

Importantly, both these reports exhort us to focus less on written codes and regulations. As Hayne summarised the matter -

The more complicated the law, the easier it is for compliance to be seen as asking 'Can I do this?' and answering that question by ticking boxes instead of asking 'Should I do this? What is the right thing to do?'

Finally I recall the principles issued in 2015 by the Group of 30, the renowned international body of leading financiers and academics, when they defined the desired outcomes for a banking culture in these terms:

"We used a framework that identifies key factors that determine two broad outcomes for a bank: (a) client and stakeholder perceptions about the bank's reputation and services, and whether the bank builds trust (among stakeholders including employees, society, government, and supervisors); and (b) financial performance, which rewards shareholders."

The same principles might equally apply to all business organisations.

Hayne's Royal Commission revealed that our financial institutions had largely ignored that exhortation. The same might be said in relation to the work of this Committee in its focus on the culture of many of our consultancy service organisations. Perhaps the continued vigilance of our investigative journalists, with the appropriate supportive response of our political leaders, will give cause to our financial services institutions, indeed corporate Australia generally, to follow the Group of 30 advice - or our regulators and the courts are going to be very busy indeed.