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Attention: Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600
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Submission from Professors Ian D. Gow and Stuart Kells to the Parliamentary Joint Committee on Corporations and Financial Services

Dear Senators and Members of Parliament:

Thank you for the opportunity to contribute to the Parliamentary Joint Committee on Corporations and Financial Services. This is a timely inquiry into a matter of high public importance.

We have written and spoken extensively on the topic of the inquiry. Many themes from our 2018 book, *The Big Four: The Curious Past and Perilous Future of the Global Accounting Monopoly* have been reinforced by subsequent events, especially those related to the “PwC tax scandal” in recent months.¹ These themes include:

- The economic importance of the assurance provided by accounting firms regarding financial statements of public firms, with the Big Four – Deloitte, EY, KPMG, and PwC – having a dominant share of the auditing of the largest firms both in Australia and around the world.
- The threats to this function posed by the continued weakness of the Big Four with regard to governance, risk management, and strategy. We discussed these issues in a recent piece in *The Guardian*.²
- How these threats are especially heightened by certain business lines, including the provision of lucrative taxation services, that foster an excessively commercialistic culture and undermine the traditional focus of the Big Four on probity.
- How addressing these issues likely requires structural changes to the Big Four firms themselves. Since publication of *The Big Four* (2018), this need seems only to have become clearer. Unfortunately, it also seems clear that the firms will not take these steps themselves and regulatory action may be the only way forward.
- Ongoing developments in technology discussed in *The Big Four* have only accelerated since 2018 making today a unique opportunity to examine the role of the Big Four in the Australian economy.

Yours sincerely

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¹ <https://www.blackincbooks.com.au/books/big-four>.

² See <https://www.theguardian.com/commentisfree/2023/jun/04/the-big-four-firms-are-incapable-of-unwinding-their-own-deep-seated-conflicts>.

Attachments:

Video transcript: PwC tax leak scandal shines light on consulting industry practices [ABC, The Business, Wednesday 17 May 2023]

<https://www.youtube.com/watch?v=OP69-BuSbZI>

SK: A long history of these sorts of episodes going back decades, if not a century. So it's really coming out of something that is fundamental to the structure of the Big Four today. Having said that, the PwC people are right to be worried because it is pretty serious and it seems to have really galvanised people's thinking about the Big Four and what people ask them to do and what sorts of things happen inside the firms. So they are right to be worried.

Let's talk about that fundamental structure that you mentioned there. Jim Chalmers has said he is displeased with PwC and is considering further action. What does this incident say about the relationship of these large consulting firms and governments. Are they intrinsically always going to be conflicted?

IG: Oh. yeah there's always going to be issues. Clearly the government is a big customer, a big client, of these firms. But I think that also speaks to the risks, right. These firms are in such diverse areas of business – whether it's with business, whether it's with the government – that an incident like this which basically creates reputational risk that applies to, you know, was it one partner? Was it seven partners? Or was it thirty partners? We're not sure at this stage. But it's thousands of people whose livelihood is potentially affected by the potential consequences that the government might take in response to this.

Let's talk about some of those potential consequences. If the penalties in this country were perhaps stronger would this type of behaviour be prevented? I mean, what goes on overseas?

SK: Well there's all sorts of different kinds of consequences including direct legal and financial ones but also in the case of Australia the potential for an anti-corruption lense to be applied to it. Through the history of Big Four tax scandals there's been all sort of consequences but also a reluctance to go too hard against the Big Four because they're so concentrated and so all pervading. There was a fear, for example, in 2005 when KPMG were at the centre of a big tax scandal in the US. There was a fear that if it was criminally prosecuted we'd end up with the Big Three. Now I think that Ian and I would argue that it's a false analogy to think of these organisations as systemically important or as too big to fail. They're not too big to fail. They are very big. But they can fail as Arthur Andersen showed. And it would be wrong to think that they perform an essential systemic function. Because what they actually do is very contestable.

So how do you think about starting to fix the system? Because the government, you would presume, would always need some level of external consultation when creating policy.

IG: Part of it is: Are these firms too big? Are they in too many businesses? So one possibility that's being talked about – EY was certainly pursuing this – the idea was to sort of split up into multiple firms so that some of the conflicts are resolved structurally in some ways. And part of that was not only coming from EY itself but from ... there's been discussion among regulators in the US, and in the UK in particular, that there are these conflicts that maybe need to be addressed through structural remedies. And that's certainly one remedy that might be considered in the Australian context.

What are some of the other new frontiers that might exist when it comes to strengthening integrity and auditing?

SK: Well, 100% the idea of splitting auditing, which is fundamentally a pro-social activity, from things like aggressive tax avoidance which is essentially an anti-social activity. So structural remedies are very important. But we shouldn't be reluctant to apply a very high standard of integrity to these organisations and to pursue – exactly as Senator O'Neill is doing now – to pursue them very, very rigorously. So there are things people have proposed in the past, for example if a large professional services firm is engaging in inappropriate conduct banning them from government work and having other kinds of sanctions. But also thinking about the clients, because the clients are the ones looking to the Big Four for this kind of advice and they're also looking to engage with governments. So, in the UK in one of the big tax scandals there, there was a push to say, well, companies that are engaging the Big Four for aggressive tax advice should be banned from working with government as well.

Can the Big Four be trusted?

IG: I think the Big Four can be trusted if they have the right sort of incentives to be trusted. I mean they all started out to a large extent as audit businesses, sort of focussed on this reputation for probity, for ensuring that the financial reporting was done in an appropriate fashion. But what we've seen in recent years is the firms have grown dramatically. Three of the Big Four actually spun off the consulting practices around 2002, 2003 timeframe, but they've now gone back into that business and it's grown rapidly. Much more rapidly than sort of the core historical part of their business. And I think those conflicts are leading the Big Four into situations where perhaps they can't be trusted. And I think structural remedies will be something that's sort of put back onto the table, that the firm's themselves might be looking at at this stage.

What next for PwC?

SK: They are very much in damage control. I don't want to say too much about PwC specifically because Ian and I are historians of the Big Four in general. Some of the things they're doing are obviously very sensible: so, engaging people to look at culture and those sorts of things. But the risk is that they won't look at the fundamental conflicts and it's really, really hard to change those things in the Big Four because they don't have a conventional corporate structure. They have essentially a franchise structure. So things like head offices and brands are owned jointly by the national practices. So doing things like what EY planned to do with the demerger is extremely difficult because you need to get the different national practices to co-operate. So unwinding or fundamentally changing systems, integrity, is very, very difficult in the modern world that we've got at the moment for the Big Four. So one of the things that Ian and I have said is that they really need to think about different models, possibly corporate models, certainly structural change. But, again, getting agreement from the Big Four to do that voluntarily is extremely difficult.

Video transcript: PwC government carve out still leaves problems [ABC The Business, Mon 26 Jun 2023]

<https://www.youtube.com/watch?v=7y1EPFS1MdY&t=230>

The Big Four co-author Stuart Kells says the sale of PwC's government business to Allegro Funds does not solve the underlying problems of conflict between the tax and audit service arms of the company.

SK: PwC have been forced to this point. But I would emphasise that it definitely does not solve the underlying problem. The issues that Senator O'Neill and others have raised go much deeper than this particular transaction. So stepping back to what the foundational problem was it's really a conflict between different service lines, and in particular a conflict between tax avoidance advice on the one hand and then integrity focussed advice such as auditing and advice to government. Now this transaction relates to just one part of that which is the government services part. So the conflict between tax and audit will continue both in the Australian firm of PwC and in the global firm. So that problem still continues. And then specifically in the carve out of the government services part there are other issues as well.

And so does that mean that this decision is premature? Many inquiries into the what, the when and the who remain ongoing.

SK: Yeah, that's a good argument. It does look like they're jumping the gun a little bit. I'm not sure really that they've thought through the transaction as much as they might as well. About how it might be conceived and executed. A couple of examples of that: so, the new entity is going to be a corporation – a corporate structure – with the ability to raise capital, but actually the existing entity and the existing service lines probably need more capital and have more potential for automation and for capital injection – so things like auditing and tax advice, for example, are more suitable for automation and for AI for example. But also, in carving out the business in this way, there's all sorts of practical problems around existing government contracts, government panels, government client files. If I were PwC, I'd be wrapping a structure around that – a high integrity structure around that – but it doesn't seem like they've done that.

There is real anger in government ranks, from the Prime Minister and Treasurer down, about PwC's actions. Is the Allegro spinoff solution something governments can work with given the breadth and depth of work carried out for the public sector?

SK: Well the services that we're talking about – so defence advice, health-related advice, infrastructure – they're very large but also PwC's government advice, as you know, goes much broader than that. It goes to things like provision of staff and outsourcing services. It goes to advice directly to government departments like the Treasury for example. So we're talking about very significant services, but PwC's fundamentally made a strange sort of decision. Rather than keep those and jettison tax they've decided to keep the tax minimisation advice and jettison those services. So it's a big gamble for the new entity to see whether the government will continue to purchase those services from the Allegro-Bell entity that they're creating. If I were the new private equity owners I'd be pretty wary about those sorts of risks and from the PwC point of view they're retaining in a sense the services that created the problem in the first place.

Is there an argument here that the size of PwC's government business is such that it could, and possibly should, have been nationalised?

SK: Well, it's a really interesting question. Aspects of what they provide are pseudo-government services anyway and should be provided by the public service. That's

one part of the answer. In terms of the transaction itself, it will involve a very careful look at things like files and contract relationships and commitments. I would want to see a public sector scrutiny of that by a suitable body like the National Audit Office or someone like that watching closely to see how those contracts are unwound, how files are dealt with etc. And absolutely in the longer term some of these functions should definitely be publicly provided.

You already mentioned that Allegro funds should be wary of the risks in this particular deal. How much risk is it accepting and why would it accept the terms of this particular deal with PwC?

SK: Well, the one dollar purchase price is calculated to do a few things. It's calculated to make the purchaser feel that they've got a good deal and it's calculated to make the partners feel like they've got a large stake in the new business because it means there's not a large slice going off to private equity. Allegro has been pretty smart. Other private equity firms had a chance to do this deal and walked away, but Allegro, I think, has structured it in a way that is pretty safe for themselves. When you think about it, in a professional services partnership it's not like buying a listed corporation that has a disreputable of physical assets and other sorts of businesses. It really is a people-based business and the main costs relate to partners and staff, and those costs, they're limited in the downside for Allegro and there's a lot of upside in terms of removing the capital constraints, removing the innovation constraints that the Big Four face at the moment. So if I were Allegro I would be pretty happy.

Is it becoming any clearer to you what regulatory and legislative change might result to prevent similar conflicts occurring in the future?

SK: Well, this is a problem right across the big consultancies, where they're so diversified. They've got tax avoidance advice happening alongside audit, alongside advice to government and other service lines. That diversified model really has a use-by date and EY has tried to unwind it. That has, I think, been temporarily stopped because of disagreements about tax and where tax will land. But fundamentally the Big Four need to unwind these mega diversified partnerships and in general I think there needs to be much more awareness and much more scrutiny of the risks attached from these conflicting services, across all sorts of professional services.