The Institute of Public Accountants

Proposed Industry Funded Model for the Australian Securities and Investments Commission

December 2016

IPA INSTITUTE OF PUBLIC ACCOUNTANTS

Partnership beyond numbers

IPA - Deakin SME Research Centre

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In 2013, the IPA partnered with Deakin University to form the IPA Deakin SME Research Partnership, a first in Australia. This partnership has grown and evolved into the IPA assisting Deakin University in establishing the IPA-Deakin University SME Research Centre. The goal of the Centre is to bring together practitioner insights with cutting edge SME academic research, to provide informed comment for substantive policy development.

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Dear Sir/Madam

Proposed Industry Funded Model for Australian Securities and Investments Commission Proposals Paper (November 2016)

The Institute of Public Accountants (IPA) is one of Australia's peak accounting bodies and we welcome the opportunity to comment on the 'Proposed Industry Funding Model for the Australian Securities and Investments Commission (ASIC) (November, 2016). First and foremost, we commend the Government for its foresight in addressing the significant issue of funding for the regulation of the corporate sector, financial markets, financial services and consumer credit. We also believe that while the existing regulatory architecture does not require major change (Financial System Inquiry, 2014), the accountability and capability of ASIC should be strengthened. We further understand that the pressures of globalisation, advances in technology and the endless complexities driven by rapidly changing markets, now require greater and timelier regulatory responses.

In our submission, we have not taken a particularly critical perspective because, in principal and in substance, we are in support of the majority of the initiatives that have been proposed by Government. Instead, we take a more complementary approach which we believe will strengthen the Government's case for the self-funding of a significant operational arm of the legislature, that is, ASIC. In essence, our approach suggests the inclusion of further detail (particularly based on robust research results) which clearly demonstrates the benefits and the functional aspects of the proposed funding model. We also suggest that self-funding is only one of several alternatives which can reduce regulatory burdens, and in this respect,

there are other models which share regulatory burdens among several actors. This would include using the various professions to assist in monitoring and enforcement activities. In this sense, private actors can both complement the role of the regulator and also significantly reduce direct costs of regulation.

In our submission below, the IPA provides detailed support for the following recommendations:

1. The IPA proposes that Government seriously consider the establishment of a formal co-regulatory environment in which some of the responsibilities of ASIC are shared with private actors. For example, the Government should consider a horizontal co-regulatory framework for the regulation and monitoring of auditors, along with associated enforcement activities, which is equitably shared amongst key actors including; the state, the accounting/auditing professions and private industry.
2. The Government should provide more conceptual and theoretical detail on the proposed models in order to better understand the funding mechanisms that support the industry funding model. For example, the proposal does not provide any reference nor comparisons with international funding models currently being used in different jurisdictions, particularly the funding models operating in the UK, the US and in New Zealand. Support for the proposed industry funding model will be strengthened if it could be shown that the international models are successful and could work in the Australian context.
3. The proposed cost recovery approach in setting levies lacks detail, particularly as to how metrics have been structured, and the formulae for these levy metrics appear to be arbitrary.
4. The IPA recommends that Government consider undertaking further research which supports the basic assumptions underlying the manner in which levies are imposed as this will result in a more equitable allocation basis for allocating the right costs to the different user groups.
5. To enhance the Government's position in using general (flat rate) metrics or specific metrics (flat fee and graded fee) for different user groups, an activity based costing (ABC) system which identifies the correct cost drivers (ie business activities) applicable

to the appropriate group being charged could be implemented, resulting in a fairer system that appropriately allocates fixed and variable costs and which would be continually monitored via the proposed dashboard system. The accounting profession, as represented by the three peak professional bodies and their respective research partners, is well placed to undertake research of this nature.

If you would like more information or wish to discuss any of our recommendations then please don't hesitate to contact Vicki Stylianou on vicki.stylianou@publicaccountants.org.au.

Yours faithfully

Vicki Stylianou
Executive General Manager
Institute of Public Accountants

Commentary on the Proposed Industry Funding Model

The IPA welcomes the opportunity to comment on proposals to introduce an *Industry Funded Model* for ASIC, and in-principle, supports funding reforms that:

- promote equity, whereby the recipients who create the need for a government activity, rather than the general public, bear the costs;
- influence demand for government activities;
- improve the efficiency, productivity and responsiveness of government activities and accountability for those activities;
- increases cost consciousness for all stakeholders by raising awareness of how much government activity costs (Australian Government, 2016).

We also recognise the significant and important role that ASIC plays in maintaining and facilitating the performance of financial systems, along with their crucial role in maintaining confidence in capital markets by keeping market participants informed. Indeed, we support ASIC's vision to "allow markets to fund the economy and, in turn, economic growth… and in doing so, contributing to the financial wellbeing of all Australians (ASIC, 2016). We further support the role of ASIC in:

- promoting investor and consumer trust and confidence;
- ensuring fair and efficient markets; and
- providing efficient registration services (ASIC, 2016).

In order to have the capability and resources to undertake an ever increasing range of responsibilities (as articulated in ASIC's Corporate Plan, ASIC 2016), we acknowledge that ASIC needs to be supported by well-funded mechanisms. We also maintain, however, that addressing the cost of regulation may not be a simple matter of shifting the fiscal burden completely from the public purse to industry[1]. In this respect, while we support in-principle, some form of industry funding, we believe that further research needs to be undertaken to

[1] We assume that Treasury has undertaken relevant research to support the successful development and implementation of a self-funded regime in the context of the Australian institutional environment. If so, it will be useful for that information to be shared and independently assessed.

determine whether an industry funded type model is the most appropriate model to be utilised within the Australian institutional environment. If demonstrated that such a model is the most appropriate, we would also need to understand whether the specific funding mechanisms that support the proposed model (ie cost recovery using levy-metrics based systems), has conceptual support. We further argue that there are other possible measures that can alleviate both the financial and operational burdens associated with regulation. We propose that a formal co-regulatory system in which some of the responsibilities of ASIC are shared with private actors, be seriously considered. While we note in the Government's proposal (Australian Government, 2016), "that the government does not propose that industry groups be given any oversight function in relation to ASIC's decision making", we believe that self-regulation or co-regulation models that have proven to be successful in easing the regulatory burden are worthy of consideration. Indeed, the three peak bodies within the accounting profession are well placed to share the responsibility for compliance and enforcement.

We are confident that the Government will receive a significant number of responses to the current proposal covering a broad range of issues. Our focus in this submission however, is on two areas which involve the evidentiary aspects of industry funded models:

1. To review the available evidence which supports the success of these models along with their theoretical underpinnings; and
2. To review available evidence which supports the theoretical basis for the levy-metrics.

As stated above, we support the role of ASIC and recognise the need for an appropriate funding mechanism that supports that role, including an Industry Funding Model. We note, however, that unlike the initial proposal issued by the Government in August 2015 (Australian Government, 2015), no reference is made to International Funding models which were, presumably, presented in support of an industry funded model for Australia. It would have been useful for these models to have been retained and included in the current proposal, particularly the funding models operating in the UK, the US and in New Zealand. Support for the current model proposed (Australian Government, 2016) would have been strengthened if it could be shown that the international models were successful and could work in the Australian context (notwithstanding significant differences in the size of the capital markets,

the size of their economies and the differences in their respective institutional settings). Moreover, it would also have been useful for the inclusion of research findings that provide conceptual and theoretical support for industry-funded models. In the current proposal, there appears to be no supporting evidence demonstrating that industry-funded models improve regulatory outcomes (efficiency and quality for instance), or that these models provide increased benefits to market participants and whether these models enhance the integrity of the market. Many of these issues were raised by responses to the initial proposal for industry funding models (Australian Government, 2015), particularly by the Governance Institute (October, 2015), and the Australian Financial Markets Association (October, 2015), but as previously stated, these have yet to be addressed.

Accordingly, to gain further support for an industry funded regime, we recommend that further research be undertaken highlighting the success and workability of such models, along with the costs and benefits expected to be derived. Do these models work and do they improve regulatory outcomes which are in the public interest? These are the important research questions that need addressing on an empirical level. We further recommend that professional bodies representing the various industries, be involved in the research effort. For example, the accounting profession as represented by the three peak professional bodies and their respective research partners, are well placed to undertake research of this nature.

The responses to the Government's initial industry funded proposal (Australian Government, 2015), highlighted concerns regarding the cost recovery approach in setting levies, particularly the lack of detail on the manner in which the levy metrics have been structured. In addition, the formulae in some cases appear to be arbitrary (Governance Institute, 2015). We note, however, that the Government has addressed several of these issues in its current proposal (Australian Government, 2015), as has ASIC in its proposed industry funding model (ASIC, 2016), and we commend these further developments. However, we note that further research may be necessary to enhance the Government's position in using general (flat rate) metrics or specific metrics (flat fee and graded fee) for different user groups. A fairer system could, for example, be implemented by using an activity based costing (ABC) management system which (through advanced statistical analysis) identifies the correct cost drivers (business activities) applicable to the appropriate group being charged. This would also result in a fairer allocation

of fixed and variable costs which would be continually monitored via the proposed dashboard system. We recommend that Government consider undertaking further research which supports the basic assumptions underlying the manner in which levies are imposed. This in turn will result in a more equitable allocation of appropriate costs to the different user groups. As mentioned in the above recommendations, the accounting profession as represented by the three peak professional bodies and their respective research partners, are well placed to undertake research of this nature.

Co-Regulation – A Framework for Regulating, Monitoring and the Governance of Auditors in Australia

Introduction

The literature abounds with regulatory theories covering an extensive range of topics varying from the role of the regulator in reducing information asymmetry in capital markets, to regulatory monitoring and enforcement as a deterrent against fraudulent or mischievous behaviour in the governance of commercial enterprise (Deegan, 2015). While there are numerous arguments for and against regulatory intervention within mandatory financial reporting regimes in market-based economies (Deegan, 2015), and often, either rightly or wrongly cited as free-market (or silent-hand) perspectives versus pro-regulatory (or public interest) perspectives, what appears to be clear is that there continues to be a significant role in monitoring and enforcing regulation (Miller, 1995). Moreover, this important role has been articulated in the literature for many years, and even dating back to the significant works of Adam Smith (1776), who, while over-represented in the literature as a key proponent of the free-market perspective, 'was actually aware of the problems that might arise in an unregulated free-market ... and … wrote of the need for the government to be involved in the public interest to protect the more vulnerable' (Deegan, 2015 p72). This interpretation of Smith's work was further supported by Lehman (1991), along with Collison (2003) who stated that Smith (1776) "was not opposed to government action in pursuit of general welfare; indeed, he favoured it, and was acutely conscious of the dangers of undue power in the hands of capitalists' (also cited in Deegan, 2015). While there are many arguments in support of regulation, most could perhaps be encapsulated in the words of one succinct contribution of the literature; "Credible financial reporting is hard to achieve without an accounting regulatory system" (Miller, 1995)

Notwithstanding, the need for regulation and the monitoring and enforcement thereof, what has emerged in major economies, including Australia, is that regulation of companies and their auditors, cannot alone prevent corporate failure, and we continue to witness ongoing corporate scandals and collapses despite substantial increases in regulation in its various forms (Ball, 2009; Karpardis and Karprdis, 1995). Against this background, governments are now examining alternative forms of regulatory regimes; including legislative setting

arrangements as well as alternative forms of monitoring and the enforcement of regulations (Albareda, 2008). Current paradigms within the context of these alternative forms, are gravitating toward a *shared responsibility* for the cost of regulation as well as the monitoring and enforcement of regulation relating to financial reporting (Stuerer, 2013). Shared in a sense that, apart from the regulators, there are several other players' directly involved in financial reporting regimes that should contribute and share some of the burden of regulation (Stuerer, 2013). These include industry players as well as the accounting professions and private industry. Moreover, given the important role of the auditor in adding credibility to financial statements, inter alia, there is strong support for including the regulation of auditors within a co-regulatory framework (CPA Australia, 2002). Finally, globalisation and the impact of it, has created an unexpected outcome on regulation and regulators. As Miller (1995) noted more than a decade ago, "the force of the internationalisation of business and capital markets, is creating another constraint on domestic accounting policy making". He further argues that key players in the regulation domain were under pressure to ensure international comparability of financial reporting, and as a consequence, finally conceded to the full adoption of international financial reporting standards. With the ever increasing costs associated with regulation, governments are finding it increasingly difficult to fund monitoring and enforcement activities, with resources being stretched beyond what it is reasonable to fully undertake their respective regulatory roles (ASIC Annual Report 2014-15).

The objective of this submission is primarily concerned with presenting a co-regulatory framework for financial reporting and auditing, which is equitably shared amongst key actors including the state, the accounting/auditing professions, and private industry. The narrower focus of the submission is to present a horizontal co-regulatory framework for the regulation and monitoring of auditors, along with associated enforcement activities. In simple terms, a horizontal framework implies a partnership between actors, whereby most, if not all, actors are all on the same hierarchical level.

Background - ASIC, Auditors and Co-Regulation

As briefly mentioned above, auditors play an important 'credibility' role by ensuring that financial reports, which are intended to keep markets informed, transparent and ultimately efficient, are presented fairly in all material respects, or to give a 'true and fair view in accordance with the (financial reporting) framework (ASA200). However, numerous corporate scandals and collapses such as Enron, HIH, Parmalat, Royal Ahold, Worldcom, Xerox and many others in various developed economies, have raised market concerns around the world about audit quality and the public sector's' efficiency in monitoring auditors. In the ensuing time since these major collapses, there has been increasing pressure placed on government agencies to be more proactive in their regulation of financial reporting and in particular, the regulation of auditors. Indeed the Ramsey Report (2001), which reviewed the Australian requirements for audit independence and the audit function in Australia generally, proposed a significant number of measures for strengthening the Australian requirements relating to company auditing, particularly in the area of audit independence. Interestingly, in response to the Ramsey Report (2001), the Australian Government (Commonwealth of Australia, 2002) proposed the continuation of a co-regulatory environment for the regulation of auditing, encompassing the three major players; ASIC, the accounting profession, and industry. They further stated (pp13-14) that "Australia has traditionally relied on a principles-based approach, employing a mix of regulation, co-regulation and encouragement of industry best practice. This approach has worked well in Australia and the Government supports its continuation"[2].

ASIC is the Commonwealth Government regulator responsible for administering and monitoring audit regulation activities, including registration, surveillance and enforcement within Australia (ASIC Act, 2001). ASIC conducts risk-based reviews of auditors and takes

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[2] Principles-based regulation avoids reliance on detailed, prescriptive rules and relies more on high-level, broadly stated rules or principles, and these principles generally set an overall objective that must be achieved (Black, 2007). Principles-based regulation in this context implies both the tools of regulation, that is, the principles and the adoption of a more outcomes-based approach to regulating auditing. Moreover, principles-based regulation relies on professional judgement as practitioners will have latitude in interpreting provisions within the laws and standards.

appropriate action when the Corporation Act is breached. ASIC is responsible for the regulation of approximately 4,700 Registered Company Auditors and 7,100 Self-Managed Superannuation Fund Auditors (ASIC Annual Report, 2014-15), as well as Audit Firms and Authorised Audit Companies that audit listed entities.

ASIC maintains relationships with Australia's three largest accounting bodies – CPA Australia, Chartered Accountants Australia and New Zealand, and the Institute of Public Accountants - and liaises with other stakeholders on financial reporting and audit, including accounting firms, the 'Group of 100', the Australian Institute of Company Directors (AICD), various other user groups, and local and international financial accounting standard setters. ASIC also liaises with firms internationally, through the International Forum of Independent Audit Regulators (IFIAR) and thus collaborates with other IFIAR members on improving audit quality and information sharing and auditing standards ASIC 2014-2015 Annual Report (2014-15).

ASIC's audit inspection program reviews compliance with audit quality and auditor independence requirements. Registered company auditors and firms are required to comply with the Corporations Act and follow all auditing standards and other requirements that are relevant to each engagement.

All auditors, not only those auditing listed entities, need appropriate systems and processes in place to enable them to conduct independent and high quality audits. ASIC commenced an audit inspection program in 2004-05 (ASIC Website, current as at March, 2016). ASIC's audit inspection program commenced after the passing of the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9).

The objective of the audit inspection program is to promote high quality external audits of financial reports under Chapter 2M of the Corporations Act and raise the standard of conduct in the auditing profession. This helps to ensure that users can have a greater confidence in financial reports. A strong audit profession helps maintain and promote confidence and integrity in Australia's capital markets.

The purpose of the inspection program is not to benchmark the firms. ASIC's inspection focuses on audit quality and promoting compliance with the requirements of the Corporations Act, Auditing Standards and Professional and Ethical Standards. Audit firms to be inspected are selected based on a number of criteria, with an emphasis on firms auditing publicly listed or public interest entities. The inspection program captures all firms, including smaller firms (ASIC Website, current as at March, 2016).

More recently, there has been concern that a lack of resources may impair ASIC's ability to effectively perform regulatory activities, as noted in the ASIC Annual Report (2014-15). In the financial reporting and audit sectors, one ASIC staff member has to manage and oversee 144 registered company auditors on average (ASIC, 2014-15). Lacking sufficient funding and human resources may delay the efficiency of ASIC activities. For example, based on the number of surveillances that ASIC conducted in 2014-15, it is estimated that it would take ASIC approximately 17 years to conduct high-intensity surveillance of the biggest four audit firms, and 50 years for next biggest 20 audit firms (ASIC, 2014-15).

Based on the recommendations of the Australian Government's Financial Systems Inquiry (FSI) in 2013, the Australian Government is currently proposing an industry funded model to support the work of ASIC and increase its efficiency (Commonwealth Government, Treasury, 2016). The FSI was established to assess and set out a plan for Australia's financial system over the coming decade. Findings from the FSI suggest that both industry members and consumers have little understanding of the actual costs associated with ASIC supervision. Accordingly, the inquiry found that ASIC holds little accountability for the activities it undertakes and the reasons for these activities. The Government proposes that an industry funded model for ASIC could enhance the transparency of costs and funding associated with ASIC and provide more funding certainty. An industry funded model for ASIC would ensure that those companies creating the need for regulation will be responsible for the cost of regulation. This funding model proposal aims to improve the efficiency of regulation by establishing clear price signals that would influence the behaviour of regulated entities to only apply for the licenses that they will realistically need. This would ensure that oversight resources are targeted at those entities who are actually providing the services. Additionally, subjecting ASIC to more rigorous

reporting of its regulatory costs would enable industry to more easily hold ASIC accountable for its efficiency when conducting regulatory activities.

Importantly, an industry funded model would be accompanied by the introduction of additional accountability mechanisms. ASIC will be required to produce a public report at the end of each financial year outlining its performance relative to the objectives stated in the Annual Report. A Cost Recovery Implementation Statement (CRIS) will be produced annually, illustrating the costs behind fees and levies along with an explanation of how these costs have been determined. Industry will be given an opportunity to comment on the CRIS before it is finalised. Additionally, the Government will form a Cost Recovery Stakeholder Panel, comprised of representatives from the Treasury, ASIC and each industry sector, to provide views on the implementation of an Industry Funded Model. The Government will work together with ASIC and industry to improve ASIC's levy mechanisms and ensure that the levies and fees are determined accurately.

The proposed industry funded model would mean that ASIC continues to be funded in part by the Government, with a large portion of its budget accrued through charging industry levies and fees. It is estimated that in 2016-17, the Government would recover around $6 million through a levy on auditors. The proposed industry funding model would see increased self-regulation of the accounting industry. In the following paragraphs, this submission considers the efficiency of the audit industry to self-regulate and whether a co-regulation framework, as exists in other professions and industries, may be an appropriate model to regulate auditors. Various funding models in other jurisdictions are briefly explored (as they have some relevance in the overall co-regulatory movement), as well as a discussion on models where the regulation, monitoring and enforcement in particular industries/professions has been shared by various public and private actors.

We begin by briefly defining co-regulation based on the academic literature and definitions used in different jurisdictions. The submission focuses on drawing out the experiences of regulatory activities in different countries in order to understand how co-regulation may be applied in the Australian context.

What is co-regulation?

The term co-regulation is used in academic and policy literatures to describe a regulatory framework that involves participation from both the public and private sectors in the regulation of specific public policy interests or objectives (Martinez, 2013). A co-regulation strategy encourages the co-operative involvement of the private sector with a public authority, with the aim of becoming more flexible, adaptable and effective in the legislative process (Marsden, 2011).

According to Senden (2005), co-regulation is situated somewhere between legislation and pure self-regulation, while he describes co-regulation as a "conditioned self-regulation." In the European Union, a legal framework for the use of co-regulation at the European level was created in the Interinstitutional Agreement on Better Law Making. This legal framework provides a number of rules and conditions that a co-regulatory scheme must comply with, namely, that any use of a co-regulatory scheme must be consistent with community law and meet the criteria of transparency and representativeness of the actors involved. It also states that the use of co-regulation must add value for the general interest (Interinstitutional Agreement on Better Law Making Act, 2003).

Martinez et al. (2013) proposes two models of co-regulation. The first is a top-down approach in which private sector actors enforce regulation or legislative mandates drawn up by the government. In this approach a public actor appoints a private entity to undertake a specific regulatory task or, through a legal decision, and empowers the entity to perform regulatory activity. In this framework, the private sector actors are still subject to oversight and control by the public sector. The public sector remains in charge of standard-setting, verifying and approving regulation or legislation, as well as monitoring compliance of the private sector. The second model Martinez describes is a bottom-up approach, which involves collaboration between the public and private sectors, in which the public sector acknowledges, facilitates or supports the regulatory activities of a private entity. In this model public actors no longer monopolize regulation, but allow the private sector to undertake regulatory activities as well as assist in implementing public regulation or legislation. In this approach, private sector actors play significant regulatory roles, beyond what the public sector plays.

More challenging perspectives on the meaning of 'co-regulation' are articulated by Stuerer (2013), who argues that the term '*governance*' "became the catch-all concept for various forms of steering by state and non-state actors". It is the ways in which governing is carried out, without making any assumptions as to which institutions or agents do the steering (Stuerer, 2013). He further argues that co-regulation is an 'umbrella' for co-operative forms of steering in which actors from different societal domains aim to achieve common objectives or supply public services jointly. Citing Cafaggi (2001), Stuerer explains that a key feature of co-regulation is that respective practices join not only regulators from different domains, but also those who are regulated and/or the beneficiaries of regulation. Van der Voort (2015) similarly emphasises and supports the 'governance' perspective for co-regulation, and argues that there has been a shift in today's context from governing to governance. However, he explains that co-regulation is itself a paradoxical notion, representing, as it does, a horizontal concept with hierarchical implications. Notwithstanding, he explains that the co-regulation concept holds promise for public regulators wishing to target their scarce resources at non-compliant regulatees (van der Voort, 2015). Indeed, "self-regulating industries and firms may provide indicators with which public regulators can do this effectively. Co-regulation also provides a channel for self-regulating industries to apply their profound knowledge of the industry being regulated" (van der Voort, 2015).

Co-regulatory schemes can strengthen the level of monitoring and enforcement, and reduce the costs of burden for the government (OECD, 2002; Martinez, 2013). At the same time, co-regulatory schemes provide the private sector with the opportunity to apply their knowledge of the industry being regulated (Hood et al., 2001; Albareda, 2008; Hirsch, 2011; van der Voort, 2015).

Examples of Regulatory Models in Other Jurisdictions

U.S.A.

In the United States, the Sarbanes-Oxley Act (2002) established the Public Accounting Oversight Board (PCAOB), a non-profit corporation that is independent of the United States Government. The PCAOB was established to oversee the audits of the financial statements of public companies. The firms that are registered with the PCAOB range in size from sole

proprietorships to large firms that are members of large global networks. The PCAOB has four primary responsibilities:

- registration of accounting firms;
- inspection of registered firm's audits and quality control;
- the establishment of auditing related attestations, quality control, ethics and independence standards, and;
- investigation and discipline of registered public accounting firms and their associated persons for violations of specified laws or professional standards.

The PCAOB is industry funded with most of its funding coming from the companies whose financial statements need to be audited by PCAOB-registered firms and additional funds coming from registration and annual fees paid by issuers, brokers and dealers registered with the Securities and Exchange Commission (SEC).

The SEC is a government body with the task of overseeing operations of the PCAOB, including the authority to appoint and remove its five board members. Board members are appointed to staggered five-year terms after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of Treasury. The PCAOB abides by the rules and orders set in place by the SEC and auditing standards are not effective unless approved by the SEC. The SEC is also responsible for approving the budget of the PCAOB. All PCAOB inspection report findings, adverse remediation determinations and disciplinary actions against registered firms and their associated persons are subject to SEC review, and the SEC is responsible for addressing appeals of PCAOB inspection reports and disciplinary actions.

When inspecting a registered firm, the PCAOB assesses their systems for quality control as well as a portion of their audits for compliance with applicable laws, rules and professional standards. Firms that issue audit reports on the financial statements of issuers are regularly inspected by the PCAOB on an annual or triennial basis, depending on the number of audit reports provided. In the case of a serious audit deficiency, the PCAOB maintains disciplinary authority to impose sanctions and penalties. The PCAOB holds the authority to investigate and discipline registered public accounting firms and the individuals associated with those firms. When preparing and issuing audit reports, registered firms must follow the auditing and related professional practice standards established by the PCAOB.

U.K.

The United Kingdom is currently phasing in a new audit regulation regime, which is intended to be fully operational by March 2018. The Public Sector Audit Appointment Ltd (PSAA) has been established to assist in a smooth transition to the new regime and ensure that public money is accounted for and protected during the transition. The PSAA is an independent company limited by guarantee, incorporated by the Local Government Association. In addition to ensuring a smooth transition to the new regulatory regime, it is responsible for appointing auditors to local authorities; setting audit fees and overseeing audit services to relevant authorities.

The Financial Reporting Council (FRC) is an independent regulator responsible for the oversight of the regulation of auditors by recognised accountancy firms. Specifically, the FRC is responsible for the recognition, supervision and de-recognition of Recognised Supervisory Bodies (RSB) and Recognised Qualifying Bodies (RQB). The Recognised Supervisory and Qualifying bodies have the regulatory responsibilities for supervising the work of auditors and/or offering an audit qualification. These recognised accountancy bodies have the direct responsibility of regulating their members. As recognised bodies they are required to have effective arrangements in place to ensure that their audit qualifications meet the statutory requirements. They must also have established effective arrangements for registration, monitoring and disciplining of auditors. Major local auditors, however, will be directly monitored by the Audit Quality Review Team of the FRC.

The FRC is a non-profit organisation holding legal rights and obligations and is co-funded by government and industry, with core operating costs funded primarily by business and the accountancy profession. The Chairman and Deputy Chairman of the FRC board are appointed by the Secretary of State for Business, Innovation and Skills. No member of the FRC board is a practicing auditor and strict rules are in place to avoid conflicts of interest between board members and companies that are regulated.

The FRC is supported by three committees: the Codes and Standards Committee, the Conduct Committee, and the Executive Committee. These three committees provide advice relating to codes, standard-setting and policy, advice on matters relating to conduct activities, and advise

on strategic issues and day-to-day work of the FRC. The FRC reports annually on its results to the Secretary of State.

Singapore

In Singapore the Accounting and Corporate Regulatory Authority (ACRA) is responsible for the regulation of business entities, public accountants and corporate service providers. ACRA is a statutory board under the Ministry of Finance of the Singapore Government.

The ACRA board is appointed by the Minister of Finance. The Board consists of 11 to 16 members and must include one public accountant and one non-practising accountant. Members of the current Board include individuals from the business, investment and regulation communities, the legal and audit profession, as well as users of financial reporting. In order for ACRA to maintain its independence, the majority of the board members are not practising auditors.

The Public Accountants Oversight Committee (PAOC) was established to assist ACRA in the regulation of the public accounting profession. The PAOC is made up of experienced professionals from the public service, the business community, and the audit profession. Members of the PAOC are appointed from amongst the ACRA Board, as approved by the Minister. To ensure the independence of the PAOC, the majority of its members are not practicing public accountants. The PAOC is responsible for registering, monitoring, investigating and disciplining public accountants and accounting entities. It is also responsible for setting standards for the provision of public accountancy services as well as the codes of professional and ethical conduct.

ACRA is industry funded. The main source of funding for ACRA comes from statutory fees including filing and registration fees for businesses entities and from information service fees related to those business entities. Fees are collected from audit inspection activities but these are below cost recovery and make up an insignificant proportion of ACRA's income. ACRA's funding can therefore not be reasonably influenced by the audit profession. Generally, auditing firms are inspected annually or triennially depending on the share of market capitalization of listed companies that they audit.

Examples of Co-regulatory Models in Other Industries

There are numerous examples of co-regulatory models where the partnership between government and societal actors have been successful in governance, some of the more interesting are mentioned here and include, the legal profession in Australia (Victoria, mentioned in this example), the advertising industry in the UK, and an area of financial reporting that has significantly transitioned from self-regulation to co-regulation, namely, Corporate Social Responsibility.

Legal Profession

The legal profession in Australia (the Victorian chapter is emphasised here) has for many years been a self-regulating profession, with their respective law societies performing the primary role of regulating the profession in general, including dealing with client complaints as well as several other practice matters. Indeed, as explained in "Trends & Challenges in Lawyer Regulation" (*Fordham Law Review,* 2012) "self-regulation and independence have been a fundamental part of a lawyer's self-identity for many decades, if not centuries" (Reynah Tang LIV, 2013). Moreover, as stated in the Law Institute's Presidents Blog (Victoria, 2013), self-regulation is even recognised by the United Nations in its Basic Principles on the Role of Lawyers (1990);

"*Lawyers shall be entitled to form and join self-governing professional associations to represent their interests, promote their continuing education and training and protect their professional integrity. The executive body of the professional associations shall be elected by its members and shall exercise its functions without external interference.*" (United Nations 1990, par 24)

Since 2005, the legal profession in Victoria made the transition from self-regulation, to co-a co-regulatory regime with the establishment of the Legal Services Board and Commissioner, following the passing of amendments to the Legal Profession Act (2004). This effectively resulted in the Board acting as an independent regulator for the legal profession. Within the amendments to the Legal Profession Act (2004) included a provision for the Law Institute of

Victoria (LIV) and the Victorian Bar to be involved in the regulation of the profession by delegation from either the Legal Services Board (LSB) or Legal Services Commissioner (LSC) (Reynah Tang LIV, 2013), which was clearly a shift away from full "self-regulation" to a model of "co-regulation". Accordingly, as explained by the LIV president, the LIV has continued to play a pivotal role in investigating complaints, which can include civil costs disputes to more serious allegations around fraud and conflicts of interest. "We have always taken this responsibility very seriously, and consider it vital that we continue to perform this function" (Reynah Tang LIV, 2013). Tang (2013) further states that "It is clear that the system is working"… and to quote NSW Legal Services Commissioner *Steve Mark* from over a decade ago, a "co-regulatory regime is, in my view, the best existing model for regulation of the legal profession as it encourages the profession to continue on its path of self-regulation and improvement. It would be counter-productive if the role of the professional associations were limited to defending its members against charges of misconduct as this would create an adversarial relationship between them and my office and also be of concern to the ethical members of the profession that their association was acting as an advocate for the worst of its members" (Tang (2013).

Tang (2013) further explains the "amount of work that has been done over the past few years to move towards national profession reforms, which the LIV support because they will remove barriers to movement and flexibility in the profession, is essential if we are to meet the challenges confronting us. Given Victoria is the host jurisdiction of these reforms, it is important we can demonstrate that the system works and accommodate the involvement of the profession in a manner which works to reduce the overall regulatory burden and cost".

The Advertising Industry

The advertising industry in the UK challenged the assumption that statutory control should remain for broadcast advertisements, following the issue of a White Paper by the UK government in December 2000 (Brown, 2006). The purpose of the White Paper was to make recommendations to 'manage the implications of media convergence'. The industry was concerned, however, that statutory regulation was relatively 'inflexible' compared to self-regulation, and accordingly wanted to be an integral part of legislative reforms that would shape the industry's future. The challenge for the industry was not only to be part of the

reform agenda, but also to take ownership of codes that would affect its members. There were extensive submissions to the White Paper, which recognised the role of self-regulation and co-regulation within the new regulatory framework, but the draft bill that followed did not make reference to self-regulatory solutions (Brown, 2000). An intense period of lobbying followed to overturn this apparent exclusion, and by leveraging on the success of the industries' long history of self-regulation, particularly in respect of 'advertising content', the industry was successful in its efforts. An amended bill was subsequently issued which included powers for the regulator to 'contract-out' functions appropriate to promoting effective self-regulatory solutions

The industry, as represented by the Advertising Association (AA), was acutely aware and publicly acknowledged the need for reform and the introduction of sensible rules and codes of practice. Moreover, given the significant role of advertising in economic activity, it became increasingly evident that consumer protection needed to be an integral part of the intended legislative reforms. Against this background, AA recognised that the advertising sector had to shed the mistrust that surrounded it and the attendant culture that evolved as a consequence, acknowledging that old and separate forms of regulatory structure were becoming increasingly redundant and not 'fit-for-purpose' for the new emerging media landscape (Brown, 2006). The advertising business also maintained that to "be effective, a self-regulatory system must be inclusive, [have its] own codes, be effectively funded, and have a system with effective sanction" (Brown, 2006). Some years later, the new singular regulatory system still exists with the flexibility to confront a changing landscape and "It has business support, regulatory approval, and consumer confidence" (Brown, 2006).

Corporate Social Responsibility

The corporate social responsibility (CSR) movement is a global phenomenon which has witnessed significant changes to the structure of societies, including the emergence of co-regulatory relationships between corporations and their stakeholders (Albreda, 2008). The corporate accountability movement emerged at the end of the last century as one of the most influential phenomena of global civil society, questioning the blind and irrational domain of free markets as advocated by large firms (see Bendal, 2004; Held and McGrew, (2002). Albreda explains that on a global level, CSR reinforces the involvement of non-government authorities

in reorienting political skills: “Global change implies the end of government primacy and the appearance of governance. This in turn implies an enormous variety of actors and shapes, emphasising a dynamic proliferation of process, with contradictory local and global trends and cohesions and conflicts” (Albreda, 2006). Moreover, one of the most common denominators of global governance, is the growing participation by firms in tasks that were once the domain of public authorities (Albreda, 2006, also cited, Cutler et al 1999, and Scholte, 2001). CSR has also transformed financial reporting frameworks, with companies now, more than ever, voluntarily disclosing volumes of information relating to their social and environmental performance.

Anecdotal evidence suggests that voluntary disclosures of social and environmental information in financial reports have been occurring for more than a century (Deegan, 2014), although these types of disclosures have arguably only become more wide-spread since the early nineties (particularly, for instance, in market-based economies such as in the UK, the US, Singapore, Australia). Elkington (1997) was among the first wave of studies that identified a significant need for structured CSR, arguing that firms should not only be accountable for their economic performance, which should be properly disclosed in annual reports, but should also provide information in these reports on their social and environmental performance. Elkington (1997) referred to this type of reporting as *Triple Bottom Line*, a term which has since gained considerable popularity in the literature. Indeed the literature has been extended extensively to include ethical considerations relating to role of directors in steering the corporate ship. In this sense, the focus has been on whether directors have a moral obligation toward the rights of members of society generally, for example as cited by Deegan (2014), in terms of:

- Interaction with the local community;
- Level of support for community projects;
- Level of support for developing countries;
- Health and safety issues;
- Training, employment and education issues, and;
- Environmental performance.

These initiatives are a considerable shift from traditional lines of accountability that focused purely on the financial accountability aspect of directors, but rather attending to the needs of shareholders and other stakeholders among the communities and environments in which they operate. This traditional line of accountability was the dominant paradigm in the economics literature for some years, particularly the view of the post- modernism era economist Milton Friedman (1968), who once argued that the only role of directors was to increase the wealth of shareholders. He further argued that as long as laws were not broken, directors had no other responsibilities to any other party. Interestingly, from a legal perspective, the views of Friedman are still supported. For example, corporate laws in many countries, such as for instance the U.K., the U.S., and Australia, reflect a shareholder supremacy perspective. In the case of Australia, in particular, directors are still obliged by law to "*act in good faith in the best interest of the corporation" (Corporations Act 2001, s181)*; an obligation which has been interpreted in case law, as one where directors must act in the best interests of the majority of shareholders (*Greenhalgh v Arderne Cinemas Ltd* [1951]). It should be noted though that whilst this may continue to be the legal position, directors do indeed have wider moral obligations to act in the best interests of other stakeholders and the environment through constructive and moral obligations imposed by society.

Time and time again this new wave of director obligations has been the consequence of activities and events that have exposed firms to societal pressure. These events have included market failures (such as the recent global financial crises triggered by sub-prime lending), major corporate collapses (such as Enron and Worldcom, triggered by greed and fraud), environmental disasters and social misbehaviour (such as the BHP Joint Venture in Brazil in which scores of people were killed and injured due to land erosion caused by mining, the Exxon Valdez and BP oil spills in the Gulf, the James Hardie asbestos disaster, the BHP OK Teddy river pollution disaster, the Bhopal toxic gas disaster in India, the Chernobyl nuclear reactor disaster in the Ukraine (former Soviet Union), the exploitation of child labour allegations made against Nike and other firms), and so on. All of these cases and many more have led to heightened concerns by society regarding the responsibility of directors to society and the environment. Undeniably, climate change (formerly termed *global warming*) has led to even further concerns regarding the effects of business activities on the ecology of the world, in turn leading to countless initiatives supporting sustainable development. Thus, given

the above scenarios, directors have serious motives to protect members of society and the physical environment in which they live. These motivations and incentive alignment mechanisms are posited in several current paradigms, including *legitimacy theory, stakeholder theory*, and *institutional theory*

The paradigms which explain why directors have incentives to consider the interests of stakeholders other than shareholders, revolve around three basic theories - *legitimacy theory, stakeholder theory*, and *institutional theory*. All of these theories can collectively be classified as systems-oriented theories, which as explained by Gray, Owens and Adams (1996), "*permit us to focus on the role of information and disclosure in the relationships between organisations, the State, individuals and groups*". It is assumed in these theories, that the firm can be influenced by the views of society and, in turn, firms can influence the society in which it operates. In this sense, the role of information is critical (particularly accounting information and other information disclosed in public documents, such as for example annual financial reports) because it can act as the primary influencing mechanism to manage relationships between the firm and the outside world.

The above examples and theories not only explain the various incentives for managers to disclose vital information, but they also explain the successful co-existence of various actors in meeting community expectations, i.e., with and without the involvement of state authorities.

A Proposed Model of Co-regulation for Auditors

In the above discussion we focused on succinctly explaining the existing regulatory environment and institutional arrangements for financial reporting in Australia, and the concomitant regulatory oversight of key players in the reporting process, including directors, accountants and auditors. We also briefly examined the reporting and oversight regimes in other jurisdiction, such as the UK, USA, and Singapore, along with, some of the theoretical aspects of regulation per se (free-market and pro-regulation perspectives). The issue of financial and resource constraints facing regulatory regimes (fuelled by globalisation and growing information needs of rapidly changing local and internationally markets), was also raised and it highlights an urgent need for governments to recognise other forms of

regulation. This led to a detailed discussion of co-regulation as a possible mechanism to more efficiently and effectively regulate and monitor key actors in the financial reporting arena, while at the same time reducing the financial and physical burdens on the corporate regulator. Finally, we presented three scenarios in which co-regulation between various parties were successfully working.

In light of the above discussion, we consider the following question: "Should Government consider re-instating the accounting profession in one form or another as key actors in the governance of auditors?"

Before answering this question, we revisit why the profession lost its privileged role in co-regulation in the first instance? In other words, what changed so dramatically allowing government to by-pass the existing co-regulatory arrangements, which were seemingly working well and endorsed by government (see particularly, Commonwealth of Australia, CLERP 9 Proposal, 2002). It would be fair to say, given the countless articles and research papers over the last 10-15 years, the profession generally suffered significant reputational damage following the collapse of Enron, WorldCom and HIH (in the Australian context), along with the collapse of Arthur Anderson (Ball, 2009). These collapses and others, created the perception which became what is now commonly described as the 'expectation gap'. Regrettably, it also resulted in the loss of confidence and trust in the audit profession. Miller (1995) further argues that Australia was 'infected with global madness, and along with the biggest array of corporate collapses in Australia's history, the 1980's also witnessed wide-ranging regulatory failure. In this context, regulatory performance was evaluated in terms of the 'greatest doubt' in the mind of the community, with respect to the effectiveness of auditors and the capacity of the AASB to deal with future challenges given its perceived past mistakes (Miller, 1995). Moreover, the extent of these failures significantly contributed to a climate of major reform. It also meant that after the fallout, the regulatory arrangements at that time, which were positioned somewhere between "associationism" (i.e., reliance on the market and the community through self-regulation of profession association) and "corporatism" (i.e., the government acting more as an overseer and leaning to private-sector associations to achieve public interest goals), had moved to a more "legalism" framework (i.e., the exclusive reliance on the legislative and coercive powers of the government) (Miller,

1995). The failures also led to widespread criticisms of auditors, somewhat typified in the comments of Sykes (1994), who stated that" If the audit profession cannot function anymore usefully than it did in Australia in the 1980's, then it might as well be abolished" (cited in Miller, 1995).

Miller (1995) provides qualified support for pro-regulation by arguing that no advanced market-oriented country has a financial reporting system that relies solely on the market and self-regulation. In the same context, the author also argues that for most countries, the issue is not whether government regulation is better than private sector regulation, but more a matter of whether the balance between the two is correct (citing Bromwich, 1992, p252). This important point can perhaps be the starting objective for justifying a revisit to the co-regulation movement.

What is evident, despite being derailed in the early eighties for reasons explained above, is that co-regulation of the accounting profession has not only worked well in the past, but co-regulatory models have also been supported by authoritative parties for decades, including the Australian government (Commonwealth of Australia, 2002), the professional bodies (see CPA, 2002), and ASIC (Bosch Committee report, 1990). Moreover, there are many examples (some of which have been articulated in this paper), of successful co-regulation arrangements currently in place within industries and areas that support the changing landscape of financial reporting and accountability within local and globalized platforms.

With increasing demands being placed on the public purse to finance and resource legislative reforms, we propose that the time is perhaps opportune not only to consider 'user-pay' models which assist in funding seriously under resourced regulatory agencies via a levy system, but also to consider systems which share monitoring and enforcement obligations and thus ensure that responsible government agencies undertake their duties efficiently and diligently. The wider issue now is whether there are sufficient checks and balances in place, which would bolster public confidence and *trust* in a co-regulatory environment? The fundamental basis of the successful operation of any co-regulatory system is the issue of trust, which is widely agreed to be a matter of significant relevance (van der Voort, 2015). Van der Voort (2015) explains that trust fuels the viability of interactions and that trust is an individual indicator that actors involved will feel that the interaction will be fruitful (p. 505).

So where to from here? Can the accounting profession and its three peak bodies restore confidence in Government sufficiently to regain a place on the co-regulatory table? We believe the answer is an overwhelming yes, and to understand this perspective, we need to return to the Ramsey Report (2002).

The Working Party's Report (Ramsey, 2002), recommended that the corporate regulator be given authority to delegate its powers for the registration and regulation of auditors to the professional bodies. However, it also recommended the following conditions before any functions could be delegated to an accounting body, among other things, each accounting body has and will continue to maintain;

a) A comprehensive and mandatory code of ethics and other rules dealing with the conduct of members who provide auditing services;
b) Mandatory requirements for the continuing professional education of its members and for professional indemnity insurance for those members in public practice;
c) A comprehensive program for the periodic review of the work of members who provide auditing services, and;
d) Appropriate disciplinary action.

Without question, all of the above measures have been rigorously implemented and enforced by the professional bodies for many years since issues of credibility came to the fore in the early 1980's. Indeed, coupled with strong regulatory measures via the application of the tough provisions within the Corporations Act 2001 along with the by-laws of the various bodies within the accounting profession, the auditing profession is now well regulated. Given the various arguments outlined above, it is time for Governments to recognise the substantial efforts that have been made by the peak professional bodies to regain public confidence and trust, and thus concomitantly acknowledge that accountants with all their specialised industry and technical and operational knowledge, can, as they have for many years in the past, regain a joint role in setting auditing standards as well as monitoring the performance of auditors.

It has been a long standing tradition of the professional accounting bodies to educate and discipline their own, if for no other reason than for reputational purposes, that is, to ensure and maintain the prestigious and privileged status afforded to members of their profession by the public; a profession of integrity and trust.

In the end, we see this submission as one which raises several issues, but more importantly we hope that it opens a dialogue for further discussion on co-regulation of the accounting profession, with particular emphasis on areas of practice once under siege but now enjoying a good balance of strong public interest and regulatory approval, i.e., auditing. We wish to be more involved as a credible body of professionals in the ever increasing burden of regulation and monitoring, fuelled by globalisation, complexities in constantly changing financial markets, increased scrutiny from the public, and ongoing restraints on the public purse.

Consistent with the words of a former president of the ICAA (now CAANZ), we are "firmly of the view that in the long term, regulation of accountants is best done by the profession itself, on the grounds that only accountants are in the best position to evaluate professional performance" (Grice, 1993). In light of the above, we are of the view that further discussion and dialogue would focus on issues of trust, openness, neutrality, independence and greater liaison been co-regulatory actors, as well as corporate governance mechanisms for auditors. We welcome to opportunity to further discuss any of the above matters.

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