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Financial System and Services Division
The Treasury
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via email: asicfunding@treasury.gov.au

Proposed Industry Funding Model for the Australian Securities and Investments Commission

Dear Sir/Madam

Ernst & Young Australia (**EY**) welcomes the opportunity to offer its views on the Treasury Consultation Paper *Proposed Industry Funding Model for the Australian Securities and Investments Commission*.

We support the Government's direction to adopt recommendations from the Financial System Inquiry with the purpose of strengthening transparency, accountability and capabilities of the Australian Securities and Investments Commission (**ASIC**). We agree that a user pays model for government services has the capacity to assist the achievement of these objectives, if combined with oversight and cultural change.

We note most of ASIC's services are not subject to competitive forces, are not provided within a transparent services framework, and do not have measurable quality or efficiency benchmarks for user or market participants to observe.

It is our view that with the introduction of a user pays model there is increased importance for transparency and accountability for the services provided to be efficient and of a high quality. We are concerned that the current funding proposal does not address these matters. The costs to firms from a user pays model will be passed to customers and the costs will be ultimately borne by individual investments / superannuation. If the increased cost to individuals is not offset by other savings or tax reductions then it should provide a clear benefit to the capital market – which can only be achieved through increased accountability and transparency for efficient high quality services.

Movement to a user pays system provides a real opportunity to constructively challenge the existing operating model to strengthen transparency, accountability and the improve capabilities. We believe the implementation of the new funding and user pay model should be linked to an upgrade in appropriately skilled and experienced resources available to ASIC, and that the performance should be monitored through clear and transparent measures.

In relation to regulation of auditors, ASIC registers auditors and monitors performance against the AuASB standards through inspection and enforcement programs.

The costs incurred by ASIC in conducting its audit inspection program approximate \$6 million annually. These costs are proposed to be industry funded by registered auditors, which will likely result in increased charges to listed audit clients by those registered auditors, resulting in increased government charges of \$6 million plus GST to be paid by listed corporates (in addition to the user funding charge to be paid directly by listed corporates). We note that other ASIC user pays charges proposed to be levied on listed entities may reduce the audit firm's ability to recover these costs from clients placing further fee pressure on the profession.

We are concerned that the funding model proposal does not address transparency, accountability, or the capabilities of ASIC, as is appropriate in a user pays environment, which ultimately result in increased costs in the operation of the capital market in Australia. The Treasury Consultation Paper is entirely silent on how user funding for all audit regulation services by ASIC will strengthen the transparency, accountability or capability of ASIC.

The audit inspection program

The objective of ASIC's 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*". Since commencement, the inspection program has enhanced the focus on audit quality within firms and led to improved processes and practices.

However the current audit inspection program is not without significant issues in terms of timeliness, quality and effectiveness. Additionally, we note there is complexity applying a user pays model where there is **no contestable market** for audit quality inspections against the AuASB standards. We have outlined these challenges and some proposed measures to address accountability and transparency below.

Audit quality inspection by ASIC in a user pays environment has several important characteristics and challenges:

- **The scale of the service is set by the service provider** (ASIC determines the proportion of the population of listed audits to be inspected, and the criteria upon which inspection occurs)

ASIC may unilaterally increase the scale of the inspection regime and/or the cost of the service in future periods without reference to the user base. It is our view that any move to a user pay system should provide a pathway for negotiation in the event that the scale of inspections is required to be adjusted. In addition we feel a user pays system necessitates the introduction of transparent and measurable performance metrics.

- **The scope of the service is set by the service provider** (ASIC determines the resources invested in the quality inspection).

Currently ASIC competes for government funding to satisfy its responsibilities in relation to the promotion of high quality audits, which imposes an efficiency constraint and price signal. A move to an industry funded model, with no standards or benchmark for efficiency or quality in service provision, reduces the accountability of the regulator.

- **Audit quality is not an objectively scientific measurable process**, but is the application of professional judgment and interpretation of the AuASB standards applied in the context of the audit of a particular listed entity.

An inspection team's interpretation of AuASB standards may be different to those of the registered audit firm, with very significant consequences for the listed audit client, and the cost and conduct not only of that audit but other audits by the particular firm. The current service, which is proposed to be industry funded, has no mechanism for administrative review of those interpretations, or transparency in relation to ASIC interpretation of AuASB standards across multiple inspections. It is our view that a dispute resolution process should be established to adjudicate and remedy disagreements between an Audit Firm and ASIC as such disagreements result in cost and efficiency drags on participants in Australian capital markets.

A move to industry funding should be done in conjunction with the establishment of robust quality frameworks for both the provision of inspections, and suitable administrative review in relation to interpretations and findings, transparency and publication of ASIC outcomes.

In this context, as part of the Government move to an industry funded audit regulation model to promote high quality external audits of financial reports, we recommend:

- Clear specification and oversight of ASIC's service scope by an independent body in order to increase transparency, accountability, and capabilities of ASIC. In determining scope this independent body should engage with government to establish budgets with relevant caps on future increases of, for example, CPI minus an efficiency target.
- Annual, published reporting by ASIC against quality key performance targets set by the independent body (including customer satisfaction metrics). The tracking, and reporting, of such metrics will influence behavior and enhance transparency and increase quality performance of the industry funded service. We have provided examples of relevant metrics in response to question 17 below.
- A mechanism to escalate quality or performance concerns to an independent third party, akin to an ombudsman, for the customers of the service.

In relation to transactional services, the issues are similar to those above in that certain proposed funding models will result in additional costs being passed onto our clients; however, the benefits that they will receive are unclear. Additionally, given the different operating models within firms, we are concerned that the proposed levy may not be competitively neutral on implementation and a levy by individual rather than by license may result in inappropriate behaviours to minimise costs associated with registering additional individuals.

In relation to registered liquidators, significantly increasing fees on a flat basis may risk unregulated activity and a poorly serviced community which goes against the objectives that ASIC are trying to achieve with this funding reform.

We have attached our comments on some of the detailed questions posed in the Treasury consultation paper in Attachments to this letter. We have only responded to questions that are relevant to our role, particularly as auditors, liquidators and AFS license holders.

We would be pleased to discuss our comments further. Please do not hesitate to contact Tony Smith on (08) 8417 1999, Kathy Parsons on (02) 8295 6882, or myself on (03) 9288 8647.

Yours sincerely



Tony Johnson
Chief Executive Officer & Regional Managing Partner Oceania

Attachment A – General Questions Raised in the Consultation Paper

1. Do you agree that the exclusion of these activities from cost recovery is appropriate? If not, why not?

We agree that the scope of recoverable costs should be limited to activities provided by ASIC to identifiable non-government recipients. As such we agree that activities such as general policy development and ministerial support should be excluded.

We note on page 15 of the proposed Industry Funding Model that levies would be used to recover ASIC's costs of "developing advice for the Government". This would appear inconsistent with the stated premise that the "scope of recoverable costs should be limited to only activities provided by ASIC to identifiable non-government recipients".

As such in determining actual costs recovered we believe it is important that there are rigorous internal reporting regimes implemented within ASIC to ensure time on relevant cost recoverable activities/non recoverable activities are appropriately tracked to the relevant cost pool/non recoverable.

3. Do you support cost recovery arrangements for ASIC's regulatory activities being consolidated within a single ASIC industry funding model? If not, why not?

We support the Government's approach to consolidate all the fees currently recovered by other agencies on behalf of ASIC to a single ASIC Industry Model. In our view, the consolidation of all these fees will assist in establishing appropriate transparency and accountability.

11. Is the proposed approach for calculating fees-for-service appropriate? If not, why not?

The proposed approach for calculating fee for service does not consider the scalability of the service provided. Whilst we acknowledge there is a cost / benefit assessment required in determining appropriate fees in our view a more appropriate fee for service would be to have rates for a single service and rates for groupings of the same service processed concurrently. A multiple of a single charge in this instance is not considered appropriate as it not an accurate reflection of the actual cost incurred by ASIC because it does not reflect economies of scale resulting from concurrent processing.

Specifically we would note that the fee for the change of a compliance plan auditor is proposed to be \$470, when investment managers change auditors it is often for a significant number of funds (a recent auditor change encompassed about 300 funds) such that the fee would be \$141,000. Whilst the individual fee at \$470 is not unreasonable an aggregate fee of \$141,000 is significant and does not recognise the economies of scale and may even stop entities considering making a change. We recommend where funds/scheme groups are involved there could be some sort of scaling as there is for listed company's capitalisation – eg 1-10 is \$470 per fund, 11-25 is \$250 per fund, over 25 is \$110 per fund.

13. Do you support the proposed process for determining funding for ASIC's regulatory activities under an industry funding model for ASIC? If not, why not?

Whilst we note that "stakeholders would have the opportunity to comment on whether funding levels are appropriate" the mechanism through which this would occur is unclear. Additionally, an "ability to comment" is not considered to be a sufficiently rigorous framework to drive efficiency and quality in the ASIC service delivery. We are concerned that in the currently proposed framework there is no framework to address the risks of over servicing or inefficient servicing which would result in increased costs to business without increased quality in service provision. This is linked to the issue of lack of transparency and accountability metrics.

The Consultation Paper outlines comment and consultation processes and timelines without providing a rigorous process directed towards driving efficiency and quality in service provision on an industry funded model. Whilst the model may be appropriate for some of the services provided by ASIC that are clear in scope, the significant discretion involved in relation to the scale, and approach of audit quality inspections may be unsuitable for such an approach.

In our view an independent body should have an ASIC oversight role and would determine the scope of ASIC services (in conjunction with broader government budgeting controls and broader goals around an efficient capital market), assess the efficiency and quality of service levels, set relevant performance metrics (including potentially a cap and floor approach for future periods based on existing service levels, consideration of the ongoing relevance of ASIC services and potential additional services which should be provided).

The extent to which relevant metrics are attained should be considered by this independent body in assessing whether any over spend should be recovered in future years (as proposed per page 29 of the consultation paper) to ensure there is accountability by ASIC in achieving key service delivery objectives.

14. Do you think this process will provide industry with certainty as to the fees and levies to be charged? If not, why not?

The proposed system will provide industry with appropriate certainty as to fees. With regard to the levy for audit regulation providing appropriate certainty we have raised some concerns with regard to the current proposed transition / phasing arrangements in response to question 19 below. In addition we note that any future changes to fees and levies should be phased in with sufficient time to enable industry to commercially respond.

15. Are the proposed consultation arrangements on the levy mechanisms and funding appropriate?

The proposed consultation arrangements on the levy mechanisms are unclear. In our view future charges should be subject to oversight by an independent body and should be linked to both broader government policy initiatives and assessment of ASIC's historic performance against established quality and efficiency benchmarks set by the independent body.

16. Do you support ASIC's fees-for-service being revised every three years? Alternatively, would you prefer that ASIC's fees-for-service be revised more regularly?

We support the setting of fee for service on a tri-annual basis as this provides certainty to business. The tri-annual revision to fees should include a review of the efficiency in the relevant service provision and achievement of KPI's by an independent oversight panel to enhance accountability and transparency.

17. Do you have any further suggestions for enhancements to be made to ASIC's accountability structure or industry funding model? If so, please provide details.

To enhance ASIC's accountability as part of the Government move to an industry funded audit regulation model to promote high quality external audits of financial reports, we recommend:

- Clear specification and oversight of ASIC's service scope by an independent body in order to increase transparency, accountability, and capabilities of ASIC. In determining scope this independent body should engage with government to establish budgets with relevant caps on future increases of, for example, CPI minus an efficiency target.
- Annual, published reporting by ASIC against key performance targets set by the independent body (including customer satisfaction metrics). The tracking, and reporting, of such metrics will influence behavior and enhance transparency and increase quality performance of the industry funded service. We have provided examples of relevant metrics below.

- An independent mechanism to escalate quality or performance issues akin to an ombudsman for the customers of the service.

As service providers the relevant accountability measures include those relevant to individual users as well as those that relate to satisfaction of broader government objectives. We have outlined below recommended measures to form part of the user performance assessment in respect of auditor regulation. As noted above, to achieve transparency performance metrics against agreed performance targets should be determined based on the relevant performance cycle (18 months for audit inspections and annually for fee for service matters) and be made publically available.

Audit Inspection

1. Individual firm inspection reports should be completed prior to release of the public report (Efficiency Measure)
2. ASIC quality review process should be completed within two weeks of finalizing the site visit
3. ASIC should issue draft comment forms on inspections within two weeks to the finalisation of the inspection (Efficiency Measure)
4. Firms to respond to comments forms in timely manner (within two weeks)
5. ASIC should finalise comment forms with two weeks of receiving the firm's response with residual differences referred to the interpretations process (Efficiency Measure)
6. ASIC should perform remote reviews at the same location as the engagement was executed to facilitate an effective review (Efficiency Measure)
7. The ASIC inspection teams for each firm should include at least two individuals who have worked as Registered Company Auditors in the last five years (Quality Measure)
8. The ASIC engagement inspection teams should include individuals at equivalent to Manager audit experience levels. (Quality Measure)
9. The ASIC engagement inspection teams should be lead by a peer equivalent to the engagement partner with comparable level of industry expertise. These lead inspection staff should perform appropriate quality oversight to the inspection. (Quality Measure)
10. Benchmarks should be set outlining maximum weeks spent on an inspection - which would reasonably be relative to the total engagement size / weeks spent on the audit. (Quality and Efficiency measure)
11. X% of interpretation matters referred to independent body (ombudsman style process / panel of peers) determined in a manner consistent with ASIC view (Quality Measure)
12. Interpretation matters resolved with XX timeframe (Efficiency Measure)
13. Total ASIC cost to be recovered under the audit inspection program subject to relevant caps of, for example, CPI minus an efficiency target of X%. (Efficiency Measure)
14. Results from an anonymous/independent service quality assessment process to meet XX benchmark and/or improve XX % over prior years? (Quality Measure)

Auditor Registration and resignation

1. ASIC should process applications with X weeks of receiving the application. Any queries or requests for additional information should be provided with X days. (Efficiency Measure)
2. Processing of auditor resignation forms should be subject to a timing measure (Efficiency Measure)

Audit Enforcement Activities

1. X% of enforcement actions undertaken by ASIC should be successful (Quality Measure)

18. How should the Cost Recovery Stakeholder Panel operate? How should the membership be determined?

The cost recovery panel could have a remit broader than cost recovery and could, if appropriately resourced, be the independent referral/ombudsman style body referred to above. Alternatively, these roles could be filled by the FRC.

In terms of cost recovery the panel representatives should include government, Industry bodies such as the Institute of Chartered Accountants and representation from large user bodies.

19. Are the proposed arrangements for phasing in cost recovery levies appropriate? If not, what alternative approach would you suggest and why?

It is appropriate to adopt a phasing process for cost recovery, however the current proposed timeframe to commence billing is considered unreasonable as it will result in a levy being paid by audit firms which will be not be determined (nor an estimate provided) until after commercial arrangements for audit fee services for the relevant year have concluded. In our view the timing of the implementation of the levy recovery should be deferred for one year with the levy being calculated (and not charged) for the 1 July 2016 year as this will facilitate market participants factoring the cost of the levy into their business model and commercial arrangements in advance of the fee being charged.

We note that based on the timing of the consultation process it is not feasible to advance the timing of the initial period for which the levy is calculated as the information to determine the relevant fee base may not be available for historic periods.

Additionally, current systems within firms are not set to capture the information required by ASIC to calculate the fee allocation base and it will take time for firms to modify systems to generate this information in a manner. If the information is required for the 1 July 2016 year as currently proposed, the collation of this information will be a significant cost burden.

20. Is it appropriate to set fees to recover ASIC's costs from 1 July 2016? Why or why not?

Other than the concerns raised above relating to the timing of introduction of levies and appropriate transition, 1 July 2016 is a reasonable date to introduce cost recovery fees.

21. Are the proposed administration arrangements suitable? If not, why not?

The proposed administration arrangements add an administrative burden on audit firms as they may not have systems capable of separately identifying listed company audit fee revenue.

The proposed payment and billing cycle by ASIC is considered reasonable and will not have an adverse effect on competition.

23. Is it appropriate for the Government to handle the over or under collection of levies through a reduction or increase in the levies payable for the next year? If not, why not?

The proposal to address the over/under collection of fees through a modification to future period levies is reasonable and would not have a significant effect on effect competition.

Attachment C – AFS License

36. Do you support the proposed arrangements for AFS Licensees' levies? Why or why not?

EY would be generally supportive of the approach taken by ASIC to levy charges on a tiered basis according to the risk and type of activity undertaken under the license.

37. Will the proposed levy arrangements for AFS licensees be competitively neutral? If not, why not?

The fees under the proposed levy will not be competitively neutral given that each financial service entity has adopted a different interpretation of what is and what is not to be provided under their respective license. From an accounting firm perspective in particular, certain firms take advantage of the exemptions to financial service activities and undertake most of their activities under the protection of the Professional Standards Scheme and its limitation of liability provisions, whereas other firms operate certain activities predominantly under their licensed entity. Given there are significant differences between the accounting firms and how they operate in this regard, we consider that the proposed levy will consequently place firms in a competitively unequal position.

38. Will the proposed tiering arrangements support the growth of AFS licensees? Why or why not?

No we do not believe that the new levy will promote the growth of AFS licences. Where a flat annual fee is currently payable per year compared to a levy where fees are paid by licensee, instead of all individuals who may provide financial product advice being a representative of the licence holder, there will be pressure to limit the number of people actually providing financial product advice to a minimum to reduce costs.

39. Will the proposed levy arrangements for AFS Licensees support innovation? If not, why not?

No detail has been provided with respect to what increased levies will be used for.

42. Do you believe that a graduated approach to determining the levy payable by AFS licensees, such as responsible entities and superannuation trustees, would be preferable to the proposed levy arrangements? Why or why not?

Yes a graduated approach depending on the type of advice provided and whether client funds are being handled is the right approach.

Attachment D – Funding Model for Registered Liquidators (RL's)

43. Which of the potential levy arrangements for liquidators do you support? Why?

Neither arrangement is particularly attractive. The concern is how it was determined and the application of the \$9million of regulation cost over a small number of professionals, with a smaller number again of very active RL's. The Assets Realised Model perhaps would make sense, but the overall cost is too high and ASIC risks this cost being inadvertently passed on to the creditor base, which in most cases includes Government at all levels. Perhaps 'administratively' the 'flat' levy would make sense, though of concern is the overall cost burden to RL's. Simply applying \$9million against the number of RL's is not indicative of what the flat levy would be, as it is likely that a significant proportion of RL's would simply not see the benefit in maintaining their licence and thus push up the flat levy burden. It could act as a barrier to entry and a potential inadvertent outcome could be additional cost impinged on the creditor base, which in most cases includes as mentioned above, Government at all levels.

An unintended consequence could be an increase in the unregulated pre-insolvency financial advisor market that would lift the increase in antecedent transactions and illegal financial activity such as asset stripping and phoenix activity, thus potentially increasing the compliance burden.

Greater promotion of self-regulation and in that regard ensuring there is a closer working relationship with ARITA would have positive consequences for weeding out non-compliant RL base and potentially a reduction in compliance cost.

44. Would any of the proposed levy arrangements for registered liquidators not be competitively neutral? If so, why?

The Flat Levy model and the Number of External Administrations model will tend to have a greater cost impact on the smaller operators who rely on a volume basis eg a predominantly debtor side business and those smaller operators with lower revenue and tight margins being able to afford the Flat Levy, particularly if it is designed to cover the \$9M figure. The Assets Realised model will unfairly prejudice those RL's that tend to oversee larger matters with margin pressure as they invest more in (as most on the whole) maintaining appropriate risk management systems and employing highly skilled teams to manage the larger matters.

Attachment E – Funding Model for Auditors

47. Are the proposed levy arrangements for auditors appropriate? Why or why not?

We accept that cost recovery arrangements are appropriate, subject to the comments on accountability and transparency over the delivery of efficient high quality services and support the levy arrangements subject to the introduction of some of our recommendations above to address the transparency and accountability matters.

In addition to these general comments, we draw attention to the practical difficulties related to the actual conduct of the inspection at present. These difficulties include delays in ASIC providing findings to auditors, a lack of transparency about the rating of deficiencies, the publishing of the public report on the whole audit profession before completing the component inspections of all the individual firms and a lack of ability to resolve differences of interpretation of auditing standards. These matters represent a failure of accountability and transparency, and highlight a lack of appropriately skilled senior experienced auditors within the inspection function. The imposition of the new funding model should be seen as an opportunity to resolve these issues.

48. Is audit fee revenue an appropriate metric for determining the levy payable by entities that audit publicly listed companies? Why or why not? What alternative metric would you support?

We believe that **Listed** Company Audit Fee revenue is an appropriate basis, and likely to be superior to other alternatives. It is unclear from the consultation paper whether the intention is to use audit fee revenue from all sources or (based on example 9) listed fee revenue.

In our view it is inappropriate if the basis is total revenue from all audit services as this revenue includes amounts which, as per the Treasury consultation paper, are not the subject of inspection which is the largest cost component for audit regulation – ie large pty companies (both domestically owned and those subject to overseas ownership).

In executing the funding model clear guidance will be required on the fees to be included in the base revenue line as the definition of listed company audit fees will be subject to interpretation. For example clarity will be required as to whether to include or exclude:

- equity investments and JV's audit fee revenue (when the audits are conducted by the same firm concurrently with the listed company audit – we note that in many instances JV's and equity investments are audited by different auditors and therefore inclusion of these costs in the base could readily bias the audit fee base for allocation of ASIC funding charges);
- subsidiary audit fees in the context of a group audit where the subsidiaries are located in Australia (and therefore regulated by ASIC);
- subsidiary audit fees in the context of a group audit where the subsidiaries are located outside Australia (and therefore not regulated by ASIC and as such in our view should be excluded)

49. Will the proposed levy arrangements for auditors be competitively neutral? If not, why not?

As far as we can see the levy will be competitively neutral to audit firms, although the cost will create a minor additional cost to entities operating as listed companies, or as AFS Licensees. We note that the linkage of the charging basis to listed entities, which would result in an additional cost for listed entities, and would therefore result in an increased compliance burden that places listed entities at a competitive disadvantage to other entities (private or subsidiaries of overseas entities) who will not incur this additional cost.

Attachment G – Proposed Fee Schedule

59. Do you think that the proposed fee amounts may act as a disincentive for some entities from submitting a professional registration or licence application, or a document for compliance review, with ASIC? If so, why?

We believe the proposed increases of Fees-for-Service for Professional Registration Forms (Table G1) are significant and do not allow for multiple applications. For example, previously when an investment fund manager changed compliance plan auditors for their 300 funds, the historic fee paid to resign was \$11,100 (\$37 x 300); however under the proposed new fees we would be liable to pay \$141,000 (\$470 x 300). It is in our opinion that a scaling fee (e.g. 1-10 is \$470 per fund, 11-25 is \$250 per fund, over 25 is \$110 per fund), or fee capping may be more appropriate where multiple funds/schemes are involved. This consideration applies to resignation applications – forms P-5113 and P 5132.

With respect to the proposed AFS license and liquidators regimes, there could be a risk that fees payable by user rather than by volume of work could be prohibitive and result in unlicensed and unregulated activity.