

Why private interest theory should be used to evaluate the adequacy of the auditor independence requirements in CLERP 9¹

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Note: This paper is in draft form and contains preliminary findings. Please do not cite this paper without the author's permission. The findings from this paper will form part of the author's current doctoral thesis in relation to the auditor independence requirements in CLERP 9.

INTRODUCTION

An independent audit process has the potential to enhance the credibility and integrity of financial reporting. It is envisaged that the findings from this paper may contribute to the formulation of practical proposals for legal reform (where applicable) where the existing requirements serve private interests rather than the public interest.

A key area for reform as part of CLERP 9 was auditor independence. CLERP 9 enhanced auditor independence requirements through a number of reforms including general and specific independence rules embedded into the *Corporations Act 2001 (Cth)*.

The main objective of this paper is to establish why private interest theory should be selected to evaluate the current regime. The findings from this paper will contribute to the author's current doctoral thesis which will use private interest theory as a basis to examine the adequacy of the auditor independence requirements in CLERP 9 ("**current regime**").

Private interest theory acknowledges that individuals form into groups to pursue their self interest. This theory proposes that private interests rather than public interests dominate the regulatory process. Regulatory outcomes reflect the interests of the most powerful group.³

¹ *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (Cth)*

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³ See generally, George Stigler, 'The Theory of Economic Regulation' (Spring, 1971) 2, No. 1 *The Bell Journal of Economics and Management Science* 3-21. In adopting private interest theory, this paper however does not seek to prove Stigler's theory that the politician's vote can be bought. As such, this paper will not seek to investigate whether regulatory decisions can elicit campaign

This paper is presented in four sections.

Part A looks at the background to the development of the current regime. Part B provides an outline of what auditor independence is. Part C introduces private interest theory as a basis for evaluating the current regime. Part D will discuss why this theory should be used to evaluate the current regime.

PART A - BACKGROUND

The Corporate Law Economic Reform Program (“CLERP”)

The establishment of CLERP is said⁴ to have been a consequence of the decision to transfer responsibility for legislation on corporations and securities from the Office of the Attorney-General to the Department of Treasury. The perception was that this transfer of responsibility would generate a shift from an emphasis on legal regulation to economic regulation and would result in a focus on the economic impact of corporations law.⁵

The Department of Treasury indicated that the key factors driving changes to corporate regulation in Australia were globalisation and market behaviour and that the law has not kept pace with change.⁶ The Department of Treasury has identified and explained six “key principles” which are to be applied when corporate regulation is reviewed under CLERP, to ensure that regulation facilitates economic activity and job creation and that contemplated reform will not impede these objectives. The explanation of the six “key principles”, contained in the CLERP – Policy Framework document under the heading “Economic Approach to Business Regulation” is reproduced below⁷:

3.1 Market Freedom

Competition plays a key role in driving efficiency and enhancing community welfare. However, free markets do not always operate in a sufficiently competitive, equitable or efficient manner. Business regulation can and should help markets work by enhancing market integrity and capital market efficiency. At the same time, the regulatory framework needs to be sufficiently flexible so that it

contributions, contributions of time to get-out-the vote, occasional bribes, or well-paid jobs in the political afterlife.

⁴ Jean Jacques du Plessis, James McConvill and Mirko Bagaric, *Principles of Contemporary Corporate Governance* (1st ed, 2005) 149.

⁵ Ibid.

⁶ *CLERP – Policy Framework* (1997) Department of Treasury, Australia, <<http://www.treasury.gov.au/documents/267/HTML/docshell.asp?URL=index.asp>> at 14 September 2009.

⁷ Ibid.

does not impede market evolution (for example, new products and technologies) and competition.

3.2 Investor Protection

With an increasing number of retail investors participating in the market for the first time, business regulation should ensure that all investors have reasonable access to information regarding the risks of particular investment opportunities. Regulation should be cognisant of the differences between sophisticated and retail investors in access to information and the ability to analyse it.

3.3 Information Transparency

Disclosure is a key to promoting a more efficient and competitive marketplace. Disclosure of relevant information enables rational investment decision making and facilitates the efficient use of resources by companies. Disclosure requirements increase the confidence of individual investors in the fairness and integrity of financial markets and, by fostering confidence, encourage investment. Different levels of disclosure may be required for sophisticated and retail investors.

3.4 Cost Effectiveness

The benefits of business regulation must outweigh its associated costs. The regulatory framework should take into account the direct and indirect costs imposed by regulation on business and the community as a whole. What Australia must avoid is outmoded business laws which impose unnecessary costs through reducing the range of products or services, impeding the development of new products or imposing system-wide costs.

The regulatory framework for business needs to be well targeted to ensure that the benefits clearly exceed the costs. A flexible and transparent framework will be more conducive to innovation and risk taking, which are fundamental elements of a thriving market economy, while providing necessary investor and consumer protection.

3.5 Regulatory Neutrality and Flexibility

Regulation should be applied consistently and fairly across the marketplace. Regulatory distinctions or advantages should not be conferred on particular market structures or products unless there is a clear regulatory justification. The regulatory framework should also avoid creating incentives or opportunities for regulatory arbitrage.

The regulatory framework should be sufficiently flexible to permit market participants to respond to future changes in an innovative, timely and efficient manner. Regulation should be designed to facilitate predictability and certainty.

3.6 Business Ethics and Compliance

Clear guidance regarding appropriate corporate behaviour and swift enforcement if breaches occur are key elements in ensuring that markets function optimally.

The Government is committed to the strong and effective enforcement of corporate law and will continue to provide substantial resources to the Australian Securities Commission [now the Australian Securities and Investments Commission (ASIC)] to enforce the law.

Fostering an environment which encourages high standards of business practice and ethics will remain a central objective of regulation, as will effective enforcement.

These principles provide a useful tool for developing or critiquing corporate law and governance reforms.

It would appear that the public interest rationale is the overriding motivation (or at the very least, one of the main considerations) for the current regime as can be inferred from the selected excerpts (with emphasis in bold) from each of the six key CLERP principles as set out below:

3.1 Market Freedom

*“...Business regulation can and should help markets work by enhancing **market integrity** and capital market efficiency. ...”*

3.2 Investor Protection

*“...business regulation should ensure that **all investors have reasonable access to information** regarding the risks of particular investment opportunities. ...”*

3.3 Information Transparency

*“... Disclosure requirements increase the **confidence of individual investors in the fairness and integrity of financial markets** and, by fostering confidence, encourage investment. ...”*

3.4 Cost Effectiveness

*“... A flexible and transparent framework will be more conducive to innovation and risk taking, which are fundamental elements of a thriving market economy, **while providing necessary investor and consumer protection.**”*

3.5 Regulatory Neutrality and Flexibility

*“Regulation should be **applied consistently and fairly** across the marketplace. ...”*

3.6 Business Ethics and Compliance

*“... Fostering an environment which encourages **high standards of business practice and ethics** will remain a central objective of regulation, as will effective enforcement.”*

If the current regime is designed to serve private interests at the expense of the public interest, there is scope for law reform.

CLERP 9 enhanced auditor independence requirements through a number of reforms including new audit rotation rules⁸ (requiring listed companies to essentially replace their external auditors every five years), the imposition of “cooling off” periods for auditors before being able to take up a position with a former audit client⁹ and requirements for disclosure of non-audit services provided by auditors with an explanation in the directors’ report of how the provision of these services does not comprise independence.¹⁰

Other changes increased auditor accountability by requiring that auditors of listed company clients attend the clients’ annual general meeting to answer shareholder questions¹¹, extended the duty of auditors to report unlawful conduct occurring within an audited body¹², gave auditing standards the force of law¹³ (with the Auditing and Assurance Standards Board, which is responsible for setting auditing standards, reconstituted as a statutory authority under the guidance of the Financial Reporting Council), allowed registration of audit companies¹⁴, formalised auditor qualifications¹⁵ and provided jurisdiction to the

⁸ *Corporations Act 2001* (Cth) s324DA(1).

⁹ *Ibid* s324CI and s324CJ.

¹⁰ *Ibid* s300(11B).

¹¹ *Ibid* s250T.

¹² *Ibid* s311.

¹³ *Ibid* s336.

¹⁴ *Ibid* s1299B.

¹⁵ *Ibid* s1280.

Financial Reporting Council to supervise and guide auditors regarding independence requirements.¹⁶

PART B – AUDITOR INDEPENDENCE

While many definitions of auditor independence exist in the literature, in general the concept implies that the auditor has the ability to act impartially and provide an unbiased report of the client's financial health.¹⁷ It denotes the admirable quality of not being influenced or controlled by others in matters of opinion or conduct.¹⁸

Independence is an abstract concept, and it is difficult to define either generally or in its peculiar application to the public accountant. Essentially it is a state of mind. It is partly synonymous with honesty, integrity, courage and character. It means, in simplest terms, that the certified public accountant will tell the truth as he (or she) sees it, and will permit no influence, financial or sentimental, to turn him (or her) from that course.¹⁹

Independence is an essential auditing standard because the opinion of the independent accountant is furnished for the purpose of adding justified credibility to financial statements which are primarily representations by management. If the accountant were not independent of the management of his (/her) clients, his (or her) opinion would add nothing.²⁰

The reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.²¹

¹⁶ *Australian Securities and Investments Commission Act 2001* (Cth) s225 and s225A and Jean Jacques du Plessis, James McConvill and Mirko Bagaric, *Principles of Contemporary Corporate Governance* (1st ed, 2005) 161.

¹⁷ Gary Kleinman, Dan Palmon and Asokan Anandarajan, 'Auditor independence: A synthesis of theory and empirical research' (1998) 12 *Research in Accounting Regulation* 3, 4.

¹⁸ John Carey, 'The independence concept revisited' (1985) *Ohio CPA Journal* 5.

¹⁹ John Carey, *Professional Ethics of Public Accounting* (1946) 7.

²⁰ Robert Kane, Jnr (ed), *CPA Handbook* (1952) Chapter 13, 8 quoted in RK Mautz and Hussein Sharaf, *The Philosophy of Auditing*, Monograph No 6 (1961) 204.

²¹ Abraham Briloff, 'Accountancy and Society: A Covenant Desecrated' (1990) 1 *Critical Perspectives on Accounting* 5, 29, quoting former United States Supreme Court Chief Justice Burger.

Traditional literature has partitioned independence into *independence in fact* and *independence in appearance*.²²

Independence in fact is a state of mind.²³ The appropriate state of mind can be characterized by 'probity of character and belief in and adherence to an ethical code of behaviour'²⁴ and necessarily involves moral or ethical factors.²⁵

Independence in appearance consists of 'a public reputation for those attributes of character'²⁶ and appropriately visible and credible monitoring and sanctions.²⁷

To ensure independence is more apparent, the Code of Ethics for Professional Accountants identifies guidelines for maintaining independence in appearances.²⁸ In general, it means avoiding facts and circumstances that are so significant where a reasonable person would conclude that the auditor's integrity, objectivity or professional scepticism has been compromised.²⁹

The importance of auditor independence was reiterated in the HIH Final Report, where Justice Owen stated:

Auditor independence is a critical element going to the credibility and reliability of an auditor's reports. Audited financial statements play a key role promoting the efficiency of capital markets and the independent auditor constitutes the principal external check on the integrity of financial statements. The Ramsay report recognised the following four functions of an independent audit in relation to capital market efficiency:

- (a) adding value to financial statements*
- (b) adding value to the capital markets by enhancing the credibility of financial statements*
- (c) enhancing the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements*

²² RK Mautz and Hussein Sharaf, *The Philosophy of Auditing*, Monograph No 6 (1961) 205.

²³ David Flint, *Philosophy and Principles of Auditing – An Introduction* (1988) 59-61.

²⁴ Ibid 60.

²⁵ Ian Ramsay, *Independence of Australian Company Auditors* (2001) 111.

²⁶ Flint, above n 23.

²⁷ Ramsay, above n 25.

²⁸ Australian Society of Certified Practising Accountants, 'Code of Ethics for Professional Accountants APES 110' in *Auditing Assurance and Ethics Handbook* (2008) 1149-1159.

²⁹ Ibid 1151 – 1152 and Larelle Chapple and Boyce Koh, 'Regulatory responses to auditor independence dilemmas – who takes the stronger line?' (2007) 1 *Australian Journal of Corporate Law* 21, 21.

(d) assisting to lower the cost of capital to those using audited financial statements by reducing information risk.

In addition to the above functions noted in the Ramsay report, an independent audit contributes to capital market efficiency by enhancing the consistency and comparability of reported financial information in Australia.

It is widely accepted that the auditor must be, and be seen to be, free of any interest which is incompatible with objectivity. There must be public confidence in the auditor for an audit to fulfill its functions.

The responsibility of auditors to maintain independence in the carrying out of their function was stated by the US Supreme Court:

The independent public accountant performing this special function owes allegiance to the corporation's creditors and stockholders, as well as the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust [United States v Arthur Young, 465 US 805, 817-818 (1984)].

In the absence of a competently and independently performed audit, there is increased risk to the efficiency of capital markets. There is a danger that the audit report will lure users into a false sense of security that there has been an independent scrutiny of the financial report when there has not.³⁰

Auditor independence has been referred to as “the cornerstone [the very heart] of auditing” (Stewart, 1977; Levitt, 2000), without independence an audit is virtually worthless.³¹

The importance of auditors' independence to both investors and the wider economy was succinctly conveyed by Turner (2001), former Chief Accountant of the Securities and Exchange Commission (“**SEC**”) in the USA, when he stated:

“The enduring confidence of the investing public in the integrity of our capital markets is vital ... [The capital they invest] is providing the fuel for our economic engine, funding for the growth of new businesses ... and job opportunities for tens of millions of workers ... [But] the willingness of investors to continue to invest ... cannot be taken for granted ... Public trust begins, and ends, with the integrity of the numbers the public uses to form the basis for making their investment decisions ... It is the report of the independent auditor that provides

³⁰ The HIH Royal Commission, Report of the HIH Royal Commission (2003) <<http://www.hihroyalcom.gov.au/finalreport/Chapter%207.HTML>, Vol 1, [7.2.1].

³¹ Brenda Porter, Jon Simon and David Hatherly, *Principles of External Auditing* (2st ed, 2003) 45.

investors with the critical assurance that the numbers in the financial statements have been subjected to an impartial, unbiased and rigorous examination by a skilled professional. But in order for that report to have credibility with investors, to add value to the process and investors, it must be issued by a person or firm that the investor perceives is free of all conflicts – conflicts that may or will in part weight on or impair the auditor’s judgments about the accuracy of the numbers.”³²

PART C – PRIVATE INTEREST THEORY

An introduction to private interest theory

Private interest theory has been used to explain corporate law reform in the United States. However, no one has attempted to use this theory to explain auditor independence law reform in Australia.

The most important element of this theory is its integration of the analysis of political behaviour with the larger body of economic analysis. Stigler attempted to provide a theoretical foundation for an earlier notion of political theory that regulatory agencies are *captured* by producers. It assumes that regulators (politicians) are utility maximisers. Although the utility is not specified, it would seem to mean securing and maintaining political power. This means that interest groups can influence the outcome of the regulatory process by providing financial or other support to politicians or regulators.³³ Support can also be obtained from the general public, where the politician or regulator can be perceived to be proactive following a corporate collapse such as HIH. Evidence (or lack) of such support of the government’s handling of the matter can be observed through voting power. Improving auditor independence is one way the government can be seen to be proactive in the wake of the HIH collapse.

The private interest theory of regulation assumes that groups will form to protect particular economic interests. Different groups are viewed as often being in conflict with each other and the different groups will lobby government to put in place legislation that economically benefits them (at the expense of others). As an example, consumers might lobby government for price protection, or producers lobby for tariff protection. This theoretical perspective adopts no notion of public interest – rather, private interests are considered to dominate the legislative process.³⁴ The regulatory outcomes reflect the interests of the most powerful group(s).³⁵ Posner asserts that this theory is committed to the strong

³² I Lynn E. Turner, *Speech by SEC Staff: Independence: A Covenant for the Ages* (2001) <<http://www.sec.gov/news/speech/spch504.htm> at 11 June 2010.

³³ Sam Peltzman, ‘The Economic Theory of Regulation after a Decade of Deregulation’ (1989) Special Issue *Brookings Papers on Economic Activity* 2-6.

³⁴ Craig Deegan, *Financial Accounting Theory* (2001) 66.

³⁵ Peltzman, above n 33, 6-7.

assumptions of economic theory generally, notably that people seek to advance their self-interest and do so rationally.³⁶ According to Stigler, the central task of the theory of economic regulation is to explain who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources.³⁷

For the purposes of this paper, improving auditor independence is one way the government can obtain the votes it needs from the general public to be re-elected. By attempting to improve auditor independence, the government is perceived by the general public to be taking steps in the right direction to enhance the credibility and integrity of financial reporting. Whether the selected interest groups have 'bought' the government by providing financial or other support is not within the scope of this paper.

Effectively organized groups have an advantage over the unorganized individual as these groups have access to valuable resources such as information, time and money which can be utilized to protect their own more significant financial interests. As knowledge and organization consume resources, low-cost groups tend to be favoured at the expense of high-cost groups. And more important, if, as is typical in regulatory issues, the relevant groups are of widely different size, the numerically larger group will tend to be the loser. Since the number of buyers is usually greater than the number of sellers, the buyers will probably face prohibitively high costs of organization. The number of collections required and the incentives to free riding will ensure this. Moreover, because each buyer's stake in the outcome is trivial compared with that of the typical seller, it is unlikely that all buyers will know enough to reciprocate any benefits (or punish costs) at the polls unless considerable resources are spent on educating them. The larger per capita stakes yield a saving of information costs to the smaller group and their smaller numbers make for lower organization cost. Thus the main conclusion of Stigler's analysis is that the producer interest will win the bidding for the services of a regulatory agency. More generally, in any similar political contest between groups of disparate size, the compact organized interest (say, accountants) will usually win at the expense of the diffuse group (shareholders).³⁸ The general framework developed by Stigler, with its emphasis on self-interested political behaviour and the importance of organization and information costs, became a hallmark of the subsequent private interest theory literature.³⁹

The idea being promoted by the advocates of the private interest theory of regulation is that if a particular group (perhaps a minority) does not have sufficient power (which might be proxied by number of controlled votes, or by the

³⁶ Richard Posner, 'Theories of Economic Regulation' (Autumn, 1974) 5, No. 2 *The Bell Journal of Economics and Management Science* 335, 343.

³⁷ Stigler, above n 3, 3.

³⁸ Peltzman, above n 33, 7-8.

³⁹ Peltzman, above n 33, 8.

potential funds available to support an election campaign) then that group will not be able to effectively lobby for regulation that might protect its various interests. This is a view which, in a sense, has been accepted by a number of critical theorists who often argue that the legislation supporting our social system (including corporations law and accounting standards) acts to protect and maintain the position of those with power (capital) and suppresses the ability of others (those without financial wealth) to have an ability to have a great deal of influence within society.⁴⁰

Hirshleifer is of the view that it is generally in the political interest of the regulators to ensure that some benefits go to all interest groups involved, if there is a social gain to be distributed. For example, in some circumstances a technological advance might lead to a new market solution lowering cost but not lowering price-so that all the benefit would otherwise go to the producers and none to the consumers. In these circumstances the regulators would impose a price reduction, assuring that some portion of the social gain goes to consumers as well. Similarly, the regulators tend to assure that burdens are spread among all parties, if a social loss has been incurred. And where some would gain and others lose from the unconstrained market process, the regulators “lean against the wind” so as to moderate the final outcome.⁴¹ The current regime may not only be the outcome of intense lobbying among various interest groups but may also be a moderated final outcome in order for the appearance of social gain to be distributed.

PART D - WHY PRIVATE INTEREST THEORY SHOULD BE USED TO EVALUATE THE CURRENT REGIME?

It is submitted that the reason why private interest theory should be used to evaluate the adequacy of the auditor independence requirements in the current regime is because members of accounting professional bodies, managers of companies (producer group) and government officials (“**the selected interest groups**”) may have had an impact in controlling and overseeing the regulation of financial reporting.

The selected interest groups were determined after careful evaluation as these are the groups that will most likely value the outcome of any company law reform in relation to auditor independence the most. The members of accounting professional bodies have their livelihoods at stake, managers of companies (producer group) have to constantly ensure that audit expenses are kept under

⁴⁰ Deegan, above n 34, 69.

⁴¹ Jack Hirshleifer, ‘Toward a More General Theory of Regulation: Comment’ (August, 1976) 19, No. 2 *Conference on the Economics of Politics and Regulation* 241, 243.

control and government officials have the incentive to maintain their respective position of power or privilege within the community.

This is briefly discussed under the sub-headings - Members of accounting professional bodies, Managers of companies (producer group) and Government officials.

Members of accounting professional bodies

Accounting firms also make submissions as part of the accounting standard-setting process. If we are to embrace the interest group theory of regulation, we would argue that these submissions can be explained by efforts to protect the interests of professional accountants. Perhaps auditors favour rules that reduce the risk involved in an audit, as more standardization and less judgement reduces the risk of an audit, and therefore the potential for costly law suits. Evidence in Deegan, Morris and Stokes also supports the view that audit firms are relatively more likely to lobby in favour of particular accounting methods if those methods are already in use by a number of their clients.⁴² Analysts also frequently lobby regulators for increased disclosure, perhaps because they can use the information in their job, but pay only a very small amount for it (other non-users will effectively subsidise the costs of the information).⁴³

In the United States, Puro undertook a study to investigate the possible costs and benefits for one class of lobbyists-public accounting firms.⁴⁴ According to Puro⁴⁵, accounting literature has begun to speculate about the motives of various participants in Financial Accounting Standards Board (“**FASB**”) lobbying and has outlined some possible payoffs from the process. (Since 1973, the FASB has been the designated United States organization in the private sector for establishing standards of financial accounting that govern the preparation of United States financial statements. These standards are officially recognized as authoritative by the SEC).⁴⁶ However, the empirical and analytical results are limited. Indeed, much of the existing work focuses on the impact of FASB pronouncements on corporations’ stock returns, with little attention given to the potential costs and benefits to others who participate in the standard-setting

⁴² Craig Deegan, Richard Morris and Donald Stokes, ‘Audit Firm Lobbying on Proposed Disclosure Requirements’ (1990) 15, No. 2 *Australian Journal of Management* 261, 266.

⁴³ Deegan, above n 34, 67.

⁴⁴ Ibid.

⁴⁵ Marsha Puro, ‘Audit Firm Lobbying Before the Financial Accounting Standards Board: An Empirical Study’ (Autumn, 1984) 22, No. 2 *Journal of Accounting Research* 624, 624.

⁴⁶ *Facts about FASB* Financial Accounting Standards Board, <<http://www.fasb.org/jsp/FASB/Page/SectionPage> and cid=1176154526495 at 12 February 2010.

process. Since lobbyists expend resources on their activities, they presumably expect some benefits.⁴⁷

Stigler has stated that "... regulation is acquired by the industry and is designed and operated primarily for its benefit."⁴⁸ Puro asserts that this statement is assumed to hold for all regulated activities. It leads to the recognition that, in the process of regulating corporate disclosure, the FASB actually structures the way in which auditors interact with their clients, thereby determining which services clients must purchase. This view is strengthened by the fact that accounting standards have been legislated and implemented largely by accountants, notwithstanding their proposed benefit to the public at large.⁴⁹

Puro claims that the private interest theory of regulation is applicable when new disclosure rules have been required. Some of the FASB standards required new disclosures to be made. This means audit firms will have to provide clients with services either never before produced by any of them or previously produced for a subset of clients who voluntarily purchased such services. There is little doubt that the aggregate demand for audit services is increased through new disclosure requirements and the price sensitivity of those who had purchased the service voluntarily is decreased. This implies that audit firms as a group can expect additional audit fees to be generated when new disclosures are required. Under the private interest theory of regulation model, we would hypothesize that auditors will favor adoption of new disclosure rules, assuming the new business will be equally profitable to all firms.⁵⁰

However, if auditors are not identical, and if their cost structures are different because of previous specialization and consequent differential levels of efficiency in providing particular kinds of services, then there are intuitive reasons to suggest that changes in accounting rules might result in lost clients and/or reduced profits for some auditors. If new disclosure rules put a disproportionately heavy burden on small auditors, large auditors should be more likely to support new disclosures.⁵¹

The members of the Australian accounting professional bodies may have had an influence in the development of the current regime. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) potential loss of recurring fees from audit and/or non-audit clients, increase in audit costs as a result of more stringent legislation for auditors (for example, compulsory auditor rotations for listed entities) which may lead to a decrease in profits for audit firms and legal

⁴⁷ Puro, above n 45.

⁴⁸ Stigler, above n 3, 3.

⁴⁹ Puro, above n 45, 625.

⁵⁰ Ibid 627.

⁵¹ Ibid 627-8.

reform aimed at curbing or reducing their influence in the audit standard setting process. It may also be that the Australian accounting professional bodies have lobbied for the public interest.

Managers of companies (producer group)

In relation to financial accounting, particular industry groups may lobby the regulator (the accounting standard-setter) to accept or reject a particular accounting standard. For example, in Australia an Accounting Standard relating to the activities of general insurers was released in 1990 (AASB 1023: Financial Reporting of General Insurance Activities). One requirement of this standard that was particularly unpopular with some insurance firms was that their investments be valued at net market value, and any changes therein be taken directly to the profit and loss account. To a number of firms, this introduced unwanted volatility in earnings, which they considered would negatively impact on their operations. They lobbied the Australian Accounting Standards Board to amend the requirement. As another example, many corporations have lobbied the AASB to remove the requirement that purchased goodwill must be amortised to the profit and loss account over a maximum period of twenty years (required in Australia by AASB 1013), the argument being that it was impacting on their international competitiveness. The accounting standards relating to goodwill and general insurers have not been amended to take account of these concerns. If we accept the private interest theory of regulation, the lack of success must be due to the fact that a more powerful interest group favoured the alternative situation.⁵²

Watts and Zimmerman reviewed the lobbying behaviour of United States corporations in relation to a proposal for the introduction of general price level accounting – a method of accounting that, in periods of inflation, would lead to a reduction in reported profits. They demonstrated that large politically sensitive firms favoured the proposed method of accounting, which led to reduced profits. This was counter to normal expectations that companies generally would prefer to show higher rather than lower earnings. It was explained on the (self-interest) basis that it was the larger firms that would be seen more favourably if they reported lower profits. Hence, by reporting lower profits, there was less likely to be negative wealth implications for the organizations (perhaps in the forms of government intervention, consumer boycotts, claims for higher wages).⁵³

This private interest theory model has also been applied to merger control in the European Union. Shea and Chari apply this model to analyze the formulation of the EU Merger Control Regulation (“**MCR**”) and its implementation via the 1992 Nestle/Perrier merger. The MCR gave the Merger Task Force (“**MTF**”), the exclusive power to investigate and stop mergers where the merger would result in an entity having a dominant position that could significantly impede effective

⁵² Deegan, above n 34, 66-7.

⁵³ Ibid 67.

competition in the market.⁵⁴ In February 1992, the multi-national Swiss-based food conglomerate, Nestle, notified the Commission of its intention to acquire all of Perrier, a French bottled water company. The MTF believed that the proposed merger would enable Nestle and BSN (the next largest supplier of the French market for mineral water) to be collectively dominant entities in the market.⁵⁵

Nestle/Perrier represented the first major case in which the MTF investigated the matter not as a single firm dominance case but as a joint or collective dominance case.⁵⁶ Shea and Chari explain that the decision to approve the merger was based on the self-supporting private interests of the MTF, Nestle and BSN. The MTF's ultimate interest was to use the Nestle/Perrier as a test case to establish a precedent in which it could investigate and possibly prohibit mergers that would lead to oligopolistic market structures. Such a power was not clearly defined in the MCR and it would have not been possible to achieve had the MTF not accepted an alternative solution given by Nestle and BSN who sought to increase their market power.⁵⁷

Various Australian entities may have lobbied for the current regime. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) increase in audit costs as a result of more stringent legislation for auditors (for example, compulsory auditor rotations for listed entities), legal reform aimed at curbing or reducing their influence in the audit standard setting process and the creation of additional obligations on entities to disclose more information.

Government officials

Under the private interest theory of regulation, the regulator itself is an interest group – a group that is motivated to embrace strategies to ensure re-election, or to ensure the maintenance of its position of power or privilege within the community. While not strictly embracing the private interest theory of regulation, Walker and Robinson document an interesting case in which the Australian accounting profession effectively tried to impede the development of a particular accounting standard until another body threatened its position of dominance in relation to setting accounting standards. The Australian Accounting Research Foundation (“**AARF**”) (sponsored by the accounting profession) had supported the disclosure of funds statements in preference to the alternative statement of cash flows. The AARF allegedly put in place strategies to slow the Accounting Standards Review Board (the government body that subsequently became the

⁵⁴ Eric J. Shea and Raj S. Chari, ‘Policy Formulation, Implementation and Feedback in EU Merger Control’ (Working Paper prepared for the Institute for International Integration Studies, 2005) 7.

⁵⁵ Ibid 14.

⁵⁶ Ibid.

⁵⁷ Ibid 17.

Australian Accounting Standards Board) developing standards pertaining to statements of cash flows.⁵⁸ However, in 1990 the Australian Stock Exchange indicated that by 1992 it would be requiring listed companies, as part of their listing requirements, to provide a statement of cash flows in conformity with a disclosure format to be determined by the Stock Exchange. The Stock Exchange further provided that it would only introduce its own requirements if either the Accounting Standards Review Board, or the accounting profession, did not release an accounting standard pertaining to statements of cash flows. The accounting profession thereafter worked towards developing a standard, which was ultimately released in December 1991. According to Walker and Robinson, it was the threat of intervention by the Australian Stock Exchange into the domain of the accountants that motivated the accounting profession to effectively abandon their public position in support of the funds statements, and to release a standard relating to Statements of Cash Flow (AASB 1026).⁵⁹

The regulators (being the ASIC and the ASX) can be categorized as another two distinct and separate special interest groups that may have been motivated to influence the development of the current regime in order to ensure the maintenance of their respective position of power or privilege within the community. Factors that may influence their decision to lobby for or against legal reform in relation to auditor independence includes (amongst other things) legal reform aimed at curbing or reducing their influence in the audit standard setting process, the creation of additional obligations on the regulator that may increase the risk of legal proceedings being commenced against the regulator by aggrieved persons and any other action which may cause the regulator to have a reduced position of power or privilege within the community.

Conclusion

This paper provides a contextual background to the development of the current regime. Such an exercise is valuable for (amongst other things) determining the rationale for the current regime. It would appear that the public interest rationale is the overriding motivation (or at the very least, one of the main considerations) for the current regime as can be inferred from the six key CLERP principles. If the current regime is designed to serve private interests at the expense of the public interest, there is scope for law reform.

Private interest theory was selected to evaluate the current regime because it is well placed to explain the reasons for the various interest groups (members of accounting professional bodies, managers of companies and government officials) to control and oversee the regulation of financial reporting. Private

⁵⁸ RG Walker and SP Robinson, 'Competing Regulatory Agencies with Conflicting Agendas: Setting Standards for Cash Flow Reporting in Australia' (1994) 30, No. 2 *ABACUS* 119, 131.

⁵⁹ *Ibid* 67-8.

interest theory is suitable for evaluating the current regime as the selected interest groups stand to benefit the most from controlling and overseeing the development of the current regime.

It is envisaged, through the use of private interest theory, legal reform may be proposed in the area of auditor independence to the current regime. In doing so, it is important to ensure that any proposal for legal reform is consistent with the public interest and not necessarily with the original intentions of the various stakeholders (members of accounting professional bodies, managers of companies and government officials).

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