



ASIC

Australian Securities & Investments Commission

REGULATORY GUIDE 187

Auditor rotation

Chapter 2M — Financial reports and audit

Issued 12/2/2007

From 5 July 2007, this document may be referred to as Regulatory Guide 187 (RG 187) or Policy Statement 187 (PS 187). Paragraphs in this document may be referred to by their regulatory guide number (e.g. RG 187.1) or their policy statement number (e.g. PS 187.1).

What this guide is about

RG 187.1 This guide gives guidance about how we will exercise the relief power in s342A of the *Corporations Act 2001* (Act) to modify the auditor rotation requirements in Pt 2M.4 of the Act.

RG 187.2 It covers:

A our general approach to relief

see RG 187.4–RG 187.20

B criteria for relief

see RG 187.21–RG 187.50

C applying for relief

see RG 187.51–RG 187.59

RG 187.3 We have also included an **Appendix** giving an overview of the rotation requirements.

see RG 187.60–RG 187.85

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Important note: The content of this guide is based on the law as at 12 February 2007. Examples in this guide are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements. This guide does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act applies to you. It is your responsibility to determine your obligations under the Corporations Act.

A Our general approach to relief

Our policy

RG 187.4 The rotation requirements are:

- (a) the 'time-out rule' in s324DA(1); and
- (b) the '5/7 rule' in s324DA(2).

RG 187.5 The time-out rule provides that an individual who has played a significant role in the audit of a particular listed company or listed registered scheme (audited body) for 5 successive financial years is not eligible to continue to play a significant role unless the individual has not played such a role for at least 2 successive financial years. The 5/7 rule provides that an individual may not play a significant role in the audit of a particular audited body for more than 5 out of 7 successive financial years.

Note: In this guide we refer to these obligations as the 'rotation requirements'.

RG 187.6 When considering an application for relief from the rotation requirements we will seek to balance:

- (a) the interests of investors, and other users of financial reports, in being able to make an informed choice about how to invest or use their resources by reference to financial reports that are reliable and credible;
- (b) the need for financial reports to be, and to be seen to be, independently scrutinised to promote the integrity of the market as a whole;
- (c) the desire to maintain and improve audit quality by ensuring that appropriately skilled and experienced auditors are available to conduct the audit of an audited body; and
- (d) the desire to minimise the commercial impact of the rotation requirements on auditors, audit firms, authorised audit companies (AACs) and audited bodies.

Our relief power

RG 187.7 In general, we will only use our specific relief power in s342A to give relief from the rotation requirements.

RG 187.8 We will only use our general relief powers in s340 or 341 to give relief from the rotation requirements in exceptional or special

circumstances. For example, we might use s341 if we need to make a class order to provide industry-wide relief.

RG 187.9 Subject to RG 187.8, we will apply Regulatory Guide 43 *Accounts and audit relief* (RG 43) to applications for relief under s340 or 341.

Underlying principles

RG 187.10 We will exercise our relief power in a way that is consistent with the legislative intention and that balances the competing interests of auditors, audited bodies, users of financial reports and the market as a whole.

RG 187.11 The clear policy objective of the rotation requirements is to promote auditor independence. They ensure that auditors do not remain with the audited body for significant periods that may result in inappropriate relationships developing between the auditor and the audited body, compromising the independence of the audit function. Auditor independence enhances the reliability and credibility of financial reports.

RG 187.12 However, in some situations there may be tension between the rotation requirements and the desire to maintain audit quality. For example, the incoming auditor may have less experience relevant to a particular audited body and may need some time to develop specialist knowledge.

Note: Auditors can take steps to manage and mitigate any adverse impact on audit quality, especially when developing a rotation succession plan: see Tables 1 and 2 in Section B of this guide and RG 187.27–RG 187.28. For example, it may be beneficial to plan for overlapping terms for the lead and review auditor, so that both are not rotated at the same time.

RG 187.13 In addition, we recognise that, in some circumstances, auditor rotation may have an adverse commercial impact on auditors, audit firms, AACs and audited bodies.

Explanation

Our relief power

Relief under s342A

RG 187.14 Our specific relief power under s342A is limited. We can only modify the rotation requirements by:

- (a) extending the period before the time-out rule will apply (by not more than 2 successive financial years); or
- (b) extending the period before the 5/7 rule will apply (by allowing an auditor to play a significant role in the audit for not more than 1 additional financial year).

RG 187.15 We can only do this if we are satisfied that, without modification, the rotation requirements would impose an unreasonable burden on:

- (a) the audited body; or
- (b) the registered company auditor (RCA); or
- (c) the audit firm or AAC on whose behalf the RCA is acting.

Note: See Section B of this guide for a discussion of 'unreasonable burden'.

RG 187.16 Under s342A, we cannot:

- (a) give an exemption;
- (b) impose conditions on our relief;
- (c) provide relief for periods of more than 2 financial years; nor
- (d) provide relief for periods of less than a financial year.

Relief under s340 and 341

RG 187.17 Despite the limitations of s342A, we will generally not consider using our general relief powers in either s340 or 341 to grant relief from the rotation requirements. We do not think that Parliament intended us to have a broad discretionary power to grant relief from the rotation requirements. Giving us only a limited relief power (which has the effect of making rotation of auditors mandatory) is consistent with the general policy of enhancing auditor independence.

RG 187.18 However, we may give relief under s340 if we consider that the technical limitations in s342A unduly restrict our ability to grant relief that is appropriate in the circumstances (e.g. while we cannot impose conditions on relief given under s342A, we may do so under s340). For example, we may consider that relief is appropriate only on condition that an external review auditor is appointed. Such an appointment would support auditor independence during the period of relief.

RG 187.19 We might consider granting relief under s341 if we are convinced that a class order, rather than an individual instrument of

relief, is more appropriate in the circumstances (e.g. if the relief sought would provide a solution to an industry-wide problem).

RG 187.20 In either case, we will only grant relief that is consistent with the policy objectives of auditor independence and where the person requesting relief has satisfied us that, without relief, the rotation requirements will impose an unreasonable burden. Also, we will not give relief under s340 or 341 that will extend the period of relief beyond that permitted by s324DA(1) or (2).

B Criteria for relief

Our policy

RG 187.21 We can grant relief only if we are satisfied that compliance with the rotation requirements will impose an unreasonable burden on:

- (a) the audited body;
- (b) the RCA; or
- (c) the audit firm or AAC on whose behalf the RCA is acting.

RG 187.22 Tables 1 and 2 list the factors we will take into account when assessing whether a burden is unreasonable. While we may be more likely to grant relief if there is an unreasonable burden on both the auditor (or audit firm or AAC) and the audited body, it is not necessary to demonstrate this. An unreasonable burden on *one* of the audited body, the auditor, audit firm or AAC is sufficient.

Underlying principles

RG 187.23 An unreasonable burden is one that is beyond the burden ordinarily created by the rotation requirements. It is one that:

- (a) goes beyond what is based on reason or good sense;
- (b) goes beyond what is equitable; or
- (c) is excessive.

Note: See *Mazda Australia Pty Ltd v Australian Securities Commission* (1992) 8 ACSR 613.

RG 187.24 In determining whether a burden is unreasonable, we will look at:

- (a) the policy objective of the legislation i.e. that auditors of listed audited bodies rotate; and
- (b) the nature and extent of the economic or other detriment (if any) that will result from compliance (including administrative costs).

Note: The onus is on the applicant to provide evidence, as against mere assertion, to satisfy us that relief should be granted having regard to the intention of the legislative requirement and the factors outlined in Tables 1 and 2: see also RG 187.52 in Section C.

Table 1: Factors in assessing what is an unreasonable burden on an audited body**Specialist knowledge**

The rotation requirements impose an unreasonable burden if they prevent the audited body being audited by an auditor with the necessary specialist knowledge. When assessing whether specialist knowledge is required to conduct the audit, we will look at:

- (a) the nature of the audited body including what the audited body does and the industry sector in which the audited body operates including whether the auditor needs specialist knowledge about these to undertake the audit; and
- (b) the audited body's activities during the relevant financial year, including whether the auditor needs specialist knowledge about those activities to undertake the audit.

Note: The need to have specialist knowledge of the activities of the audited body should only arise in exceptional circumstances. Any issues should be able to be adequately documented in the working papers and covered in the handover to the incoming auditor. The development of specialist knowledge by incoming auditors should form part of the rotation succession plan.

Special audit requirements

We will consider granting relief where:

- (a) special audit requirements apply to the audit of the audited body (e.g. the audit must be conducted by an auditor approved by a specific regulatory body); and
- (b) there is no other auditor who can comply with these requirements.

Availability of other RCAs

We consider that the rotation requirements will impose an unreasonable burden on the audited body when, because of the nature of the audited body, it cannot access an alternative auditor who is capable of conducting the audit and producing an audit report of the required quality.

We believe that the competitive market for RCAs in Australia means that an alternative suitable auditor will be available in most cases. However, in some limited circumstances it may not be possible to find an alternative suitable auditor.

When considering the availability of other RCAs we will look at a range of factors, including:

- (a) Are there other auditors within the same audit firm or AAC that can undertake the audit?
- (b) If an individual has been appointed as the auditor or there are no auditors that satisfy paragraph (a), are there other auditors that can provide satisfactory audit services?
- (c) Is there anything about the audited body that might make it difficult to find another auditor willing to undertake the audit?

Note: For example, if the audited body is subject to a takeover bid, there may be an expectation that if the bid is successful the auditor of the bidder will become the auditor of the target. In this situation, the audited body might have trouble finding another auditor willing to undertake the audit (as there is little possibility of future audit work). The location of the audited body might also affect the availability of auditors.

Generally lack of an available eligible auditor within the same audit firm or AAC will not, of itself, impose an unreasonable burden on an audited body. In most cases, it will be possible to find an alternative suitable auditor.

Other matters

Section 342A(7) of the Act requires us to have regard to 'any other matters which ASIC considers relevant'. Matters we might consider include:

- (a) the length of time that the ineligible auditor will remain involved in the audit if relief is granted (e.g. the audited body's financial year might be shortened on a one-off basis because of relief granted from s323D and, therefore, a grant of relief may mean that the auditor will only play a significant role in the audit for a few months beyond the usual rotation date);
- (b) what arrangements the auditor plans to put in place to ensure that it can comply with the rotation requirements when the relief expires;
- (c) what compliance arrangements (if any) the auditor had in place (e.g. the auditor may have had a rotation succession plan for the audited body, which can no longer be implemented because of unanticipated events such as sudden absences); and
- (d) whether and, if so, to what extent compliance with the rotation requirements will increase audit costs for the audited body.

Table 2: Factors in assessing what is an unreasonable burden on an auditor**General factors**

We will look at a range of factors when considering whether an unreasonable burden is imposed on the auditor (or the audit firm or AAC on whose behalf the auditor is acting), including:

- (a) the size of the auditor's practice;
- (b) the location of the auditor's practice, and the location of its audit clients;
- (c) whether the auditor has developed a rotation succession plan which, for reasons outside the control of the auditor, cannot be implemented;
- (d) whether relief is sought because of any unexpected events;
- (e) what additional costs (if any) for the auditor will result from compliance with the rotation requirements; and
- (f) any other relevant matters.

Size

To determine whether the rotation requirements impose an unreasonable burden on an audit firm or an AAC because of its size, the factors we will consider include:

- (a) how many of the members of the audit firm or directors of the AAC are RCAs;
- (b) how many other RCAs are available within the audit firm or AAC (e.g. employees);
- (c) how easy is it to employ another RCA (or engage one as a consultant or contractor); and
- (d) how many listed audited bodies are audited by the audit firm or AAC.

Location

To determine whether the rotation requirements impose an unreasonable burden on an auditor, an audit firm or an AAC because of its location, the factors we will consider include:

- (a) the geographic location of the auditor;
- (b) the geographic location of the relevant audited body;
- (c) how easy it is to employ another RCA (or engage one as a consultant or contractor) in the relevant location;
- (d) whether it is possible for an RCA from the audit firm or AAC to relocate or travel to conduct the audit; and
- (e) the additional costs (if any) for the auditor if it is necessary to travel further to conduct an audit.

Other matters

We will take into account whether the auditor has developed a rotation succession plan but, for reasons outside the auditor's control, the plan cannot be implemented (e.g. because the planned incoming auditor is unexpectedly not available). In this situation, we may be more likely to consider granting relief than if the auditor, audit firm or AAC has made no effort to comply with the rotation requirements.

We will consider granting relief where there is an unexpected event that prevents the appointed auditor or the lead or review auditor from continuing with the audit and there is no other auditor in the audit firm or AAC that is eligible to undertake the audit or review.

The event must be truly unexpected (e.g. the sudden death or illness of the lead or review auditor or the planned new lead or review auditor). We will not ordinarily consider retirement by a member of an audit firm or director of an AAC to be an unexpected event as audit firms and AACs should take this possibility into account in their rotation succession planning.

Explanation

Does auditor rotation impose a burden?

RG 187.25 It is clear that in many cases compliance with the rotation requirements will be likely to impose some form of burden on the auditor or the audited body (or both). Any change to the auditing arrangements might require, for example:

- (a) the audited body to get used to the new auditor and develop a professional and arm's length working relationship, especially if the audited body has had the same auditor for a long period of time;
- (b) the new auditor to take some time to understand the audited body's business, especially if specialist knowledge is required; and

Note: The rotation requirements were introduced into the Act in 2004 with a 2-year transition period. We expect auditors to have planned how to comply with the rotation requirements, including how to ensure that the new auditor for the audited body has the requisite level of specialist knowledge and understanding of the audited body's business to conduct a high quality audit. See the discussion of rotation succession planning in RG 187.27–RG 187.28 and Tables 1 and 2 in Section B of this guide.

- (c) an increase in audit costs, especially if there is a need for the auditor to travel or relocate to conduct the audit.

RG 187.26 While we acknowledge that in many cases there will be a 'burden' associated with compliance with the rotation requirements, we do not have power to grant relief unless the burden imposed by compliance is *unreasonable*.

RG 187.27 In addition, it is the clear legislative policy that auditors of listed audited bodies should rotate. It is important to plan how to comply with the rotation requirements. We expect that auditors will develop some form of rotation succession plan to manage the handover by rotating auditors to new lead and review auditors so as to minimise the impact of the rotation requirements.

RG 187.28 Audit quality concerns could be addressed by allowing sufficient time to enable another auditor to get 'up to speed' about the audited body's business. For example, an auditor might participate in the audit of the audited body as a professional member of the audit team prior to acting as the lead auditor.

When is a burden unreasonable?

RG 187.29 Section 342A(6) provides that before we can grant relief we must be satisfied that the law, without modification, would ‘impose an unreasonable burden’. The same criterion is included in s342(1)(c), which sets out a precondition to the exercise of ASIC’s exemption powers in s340 and 341. Case law on s342 provides guidance on the meaning of unreasonable burden in s342A(6).

Note: RG 43 *Accounts and audit relief* provides guidance on when we will consider granting relief under s340 or 341, including when we would grant relief because the law would ‘impose unreasonable burdens’: s342(1)(c). We have been guided by RG 43 in developing this aspect of the policy.

RG 187.30 We consider that an unreasonable burden is one that is ‘... something well beyond inconvenient. An unreasonable burden ... must be considered to be such a burden that goes beyond what is based on reason or good sense, goes beyond what is equitable or is excessive’: *Mazda Australia Pty Ltd v ASC* (1992) 8 ACSR 613 at 625. In the same case, it was also held that: ‘The use of the word “unreasonable” indicates that the balance must be so far against the interests of the applicant as to be fairly described as overwhelming’: at 625.

RG 187.31 An earlier case proposes a different test to determine whether an unreasonable burden will be imposed involving ‘balancing the economic detriment likely to be caused to the company against the value of that information to the “users” for whose benefit the requirements of the accounting standards are intended’: *Directors of Liquid Air (WA) Pty Ltd v Commissioner for Corporate Affairs* (1989) 15 ACLR 29 at 33–4.

RG 187.32 In deciding whether an unreasonable burden would be imposed, we must consider:

- (a) ‘the nature of the audited body or bodies, including whether the activity in which the audited body or bodies engage is such that *specialist knowledge* about that activity is necessary to carry out the audit properly’;
- (b) ‘the *availability of other registered company auditors* capable of providing satisfactory audit services for the audited body or bodies’; and
- (c) ‘*any other matters* which ASIC considers relevant’ (s342A(7)).

RG 187.33 We consider that the primary policy objective of the rotation requirements is that auditors of listed audited bodies will

rotate. This view is supported by the very limited nature of our specific relief power.

Audited body

RG 187.34 As stated in paragraph RG 187.32 above, when assessing what is an unreasonable burden on the audited body, we must consider:

- (a) the need for *specialist knowledge* about the audited body's activities;
- (b) the *availability of other registered company auditors*; and
- (c) *any other matters* which we consider relevant (s342A(7)).

Specialist knowledge

RG 187.35 The policy basis for requiring auditor rotation is that auditor independence will enhance the reliability and credibility of financial reports. However, in some limited situations there may be tension between the rotation requirements and the desire to maintain audit quality.

RG 187.36 In some cases, auditor rotation might adversely impact on audit quality, for a limited time, if the new auditor has less specialist knowledge about the particular audited body. The need for specialist knowledge may arise because of, for example:

- (a) the industry in which the audited body operates; or
- (b) the complexity of the audited body's activities.

RG 187.37 Although these factors are relevant, it is unlikely that we would grant relief where only one or both of these factors apply and there are no other factors present such as unforeseen circumstances affecting rotation succession planning.

Note: The rotation succession plan should include a strategy for ensuring the incoming auditor develops any required specialist knowledge.

Special audit requirements

RG 187.38 In some circumstances, other legal requirements that apply to the audit of the audited body may affect the availability of an alternative suitable auditor. Some audits can only be undertaken by an 'approved' auditor. For example, the audit of a life insurance company or a general insurance company can only be undertaken by an auditor approved by APRA: see s84 of the *Life Insurance Act 1995* and s40 of the *Insurance Act 1973*.

RG 187.39 In this situation, it might be appropriate to grant relief where, despite appropriate rotation succession planning, there is no other eligible auditor who can comply with the special requirements. However, as our specific relief power is limited, we are unable to provide a long-term solution and the auditor and audited body will need to consider what will happen once any relief expires.

Availability of other registered auditors

RG 187.40 There are more than 5000 RCAs in Australia. With an audit market of this size we consider that in most cases it will be possible to comply with the rotation requirements and find an alternative auditor capable of providing satisfactory audit services to a listed company or listed scheme. However, in limited circumstances this may not be the case. The location of the audited body might affect the availability of an alternative suitable auditor.

RG 187.41 In some situations that alternative suitable auditor may not be a member, employee or director of the audited body's current audit firm or AAC. However, where there is not an alternative suitable auditor within the audit firm or AAC, we consider that changing to a new auditor will generally not impose an unreasonable burden on the audited body.

What is *not* an unreasonable burden

RG 187.42 We do not consider the following matters (of themselves) to be an unreasonable burden on the audited body:

- (a) the loss of the audited body's preferred auditor; or
- (b) an increase in the audit costs for the audited body.

RG 187.43 There are some matters that, while clearly relevant, do not by themselves satisfy the unreasonable burden criterion. For example, we do not consider that higher audit costs for the audited body if the new auditor takes longer to conduct the audit because of the new auditor's need to develop expertise and knowledge of the audited body's business, alone, will result in compliance with the rotation requirements imposing an *unreasonable* burden on the audited body.

RG 187.44 Auditor rotation forms part of the cost of being listed and having the benefit of access to capital through public fundraising. Increased costs following rotation are a burden created by the ordinary operation of the rotation requirements. Increased costs would only be an unreasonable burden if they were excessive or out of the ordinary.

Similarly, the loss of the audited body's preferred auditor is unlikely, of itself, to satisfy the unreasonable burden criterion.

Auditors

RG 187.45 It is clear that Parliament intended us to particularly consider using our specific relief power under s342A to grant relief for small audit firms, small AACs and auditors (e.g. sole practitioners) or to grant relief for those operating in rural and remote areas where compliance with the rotation requirements may impose an unreasonable burden because of the size or location of the auditor's practice.

Note: See background material to development of the auditor rotation requirements, including the consultation paper *Corporate disclosure: Strengthening the financial reporting framework*, Commonwealth of Australia, September 2002.

RG 187.46 However, we consider that in some situations the rotation requirements may impose an unreasonable burden on *any* audit firm or AAC, regardless of its size or location.

Size: smaller audit firms or AACs

RG 187.47 We will consider whether the rotation requirements impose an unreasonable burden on an audit firm or AAC because of its size. The rotation requirements were not intended to operate in a way that necessarily requires *audit firm* or AAC rotation, rather than *auditor* rotation.

RG 187.48 Our relief power is limited to extending the period before which auditor rotation must take place. Therefore, audit firms or AACs might want to consider 'staggering' the appointment of auditors across the listed audited bodies they audit to minimise the impact of the rotation requirements (i.e. so that not all auditors within a firm or AAC are required to rotate at the same time).

Location: auditors operating in rural and remote areas

RG 187.49 The geographic location of the auditor's practice will not, of itself, be conclusive of the need to grant relief. The relevance of location will depend on the particular circumstances of the auditor. We will take into account the number of potential audit clients within a reasonable distance of the auditor and the additional costs (if any) for the auditor if it is necessary to travel further to conduct an audit. However, the need to travel to conduct an audit will not, of itself, mean that an unreasonable burden is imposed.

What is *not* an unreasonable burden

RG 187.50 The following factors will not (of themselves) constitute an unreasonable burden on the auditor:

- (a) additional administration costs due to compliance with the rotation requirements (although these costs may be relevant to the assessment); or
- (b) an adverse financial impact on the auditor (for example, through reduced audit fee income or the loss of an audited body as a client). These costs are part of the ordinary cost of complying with the rotation requirements.

C Applying for relief

Our policy

When to apply for relief

RG 187.51 Whenever possible, an application for relief should be made *before* the affected auditor becomes ineligible to play a significant role in the audit of a particular audited body—that is, as soon as the affected auditor, audit firm or AAC:

- (a) becomes aware that the affected auditor will be ineligible to play a significant role in the audit of a particular audited body; and
- (b) concludes that compliance with the rotation requirements will impose an unreasonable burden.

Note: We will only consider an application for relief made *after* the affected auditor becomes ineligible to play a significant role in the audit in exceptional circumstances.

What to include in a relief application

RG 187.52 An application for relief under s342A should include:

- (a) an explanation of the nature and extent of the unreasonable burden that will be imposed if relief is not given. This explanation should refer to the relevant factors in Section B. For example, an application might address one or more of the following factors:
 - (i) the need for specialist knowledge about the audited body or its activities (see Table 1 in Section B and RG 187.35–RG 187.37);
 - (ii) to what extent a rotation succession plan had been developed but, for reasons outside the applicant’s control, the plan cannot be implemented (e.g. the proposed new auditor is unexpectedly unavailable) (see Table 2 in Section B and RG 187.27–RG 187.28);
 - (iii) the availability (or unavailability) of other RCAs capable of providing satisfactory audit services (see Table 1 in Section B and RG 187.40–RG 187.41);

Note 1: We can only grant relief if we are satisfied that the burden is unreasonable. We need to see specific evidence that demonstrates the nature and extent of the burden and why it is unreasonable in the circumstances.

Note 2: If an application is made on the basis of changes to costs or audit fees, we expect the application to include specific 'before-and-after' worked dollar examples.

- (b) an explanation as to why relief will not impact unduly on auditor independence and the credibility of the financial reports;
- (c) written consent from:
 - (i) the individual auditor, if the application is made by an audit firm or AAC on the auditor's behalf; or
 - (ii) the audit firm or AAC, if the application is made by an individual auditor on behalf of an audit firm or AAC; and

Note: Written consent to an application is required under s342A(3)–(4) of the Act.

- (d) an explanation of how the auditor and the audited body will ensure they can comply with the rotation requirements when any relief expires.

RG 187.53 We expect that an application will be made only with the knowledge and support of the relevant audited body. If a signed acknowledgement from the relevant audited body that they are aware of, and support, the application for relief cannot be provided, the applicant will need to explain why it has not been possible to obtain this.

Note: See RG 187.57–RG 187.58.

How to apply for relief

Read Regulatory Guide 51 *Applications for relief* (RG 51) before applying for relief.

The application must be in writing and signed by the applicant. Under s342A, an application for relief may be made by:

- an RCA; or
- an audit firm or AAC on whose behalf the RCA acts or would act for the audit(s).

An audited body cannot apply for relief.

Underlying principles

RG 187.54 Our general policy is not to grant retrospective relief: see Regulatory Guide 51 *Applications for relief* at RG 51.54–RG 51.55. An application for relief should be made well before the auditor becomes ineligible to allow us sufficient time to decide whether to grant relief.

RG 187.55 The onus is on the applicant to provide evidence, as against mere assertion, to satisfy us that relief should be granted given the intention of the legislative requirement and the factors in Section B.

Explanation

When to apply for relief

RG 187.56 Eligibility should be assessed *before* an individual consents to be appointed as auditor, engages in audit activity or plays a significant role in the audit. An application for relief should be made as soon as the auditor determines that they are ineligible to play a significant role in a future audit, so that we have time to make a decision whether or not to grant relief before the audit commences.

Support from the audited body

RG 187.57 The law allows an application for relief to be made without notifying the audited body or obtaining their consent. However, as a matter of good practice, we expect that the applicant will notify the audited body that they intend to apply for relief (*before* the application is lodged). We have suggested that an application might include a signed acknowledgement from the audited body that they are aware of, and support, the application for relief.

RG 187.58 If an application for relief is made on the basis that an unreasonable burden is imposed on the audited body, we would generally expect the application to be supported by a statement in writing and signed by the audited body describing the nature and extent of the unreasonable burden and why relief would remove or reduce that burden. If this information is not included, the application should explain why the support of the audited body has not been obtained.

RG 187.59 If we grant relief the audited body must be given written notice of the declaration made by us under s342A: see s342B. It is the applicant's responsibility to notify the audited body.

Appendix

What are the rotation requirements?

RG 187.60 Auditor rotation is one of the auditor independence requirements introduced into Pt 2M.4 of the Act by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9 Act).

RG 187.61 Under s324DA of the Act, the auditor of a listed company or listed scheme (audited body) must stop playing a significant role in the audit of the company or scheme after a certain period of time.

RG 187.62 Specifically, the rotation requirements are:

- (a) the 'time-out rule' in s324DA(1); and
- (b) the '5/7 rule' in s324DA(2).

RG 187.63 The time-out rule provides that an individual who has played a significant role in the audit of a particular audited body for 5 successive financial years is not eligible to continue to play a significant role unless the individual has not played such a role for at least 2 successive financial years. The 5/7 rule provides that an individual may not play a significant role in the audit of a particular audited body for more than 5 out of 7 successive financial years.

RG 187.64 The rotation requirements are linked to the audited body's financial year. An auditor may continue to work on the audit for the 5th financial year, even though that work occurs part way into the 6th financial year. However, the auditor cannot commence work on the audit for the 6th financial year. In some circumstances, the financial year may not be 12 months. An audited body might have an extended financial year (of up to 18 months) under s323D(3), which allows for the synchronisation of financial years where consolidated financial statements are required. Alternatively, a financial year might be less than 12 months where we have granted relief from s323D to allow this.

Who must rotate?

RG 187.65 The rotation requirements apply only to auditors conducting an audit required under Ch 2M. The rotation requirements do not apply to the auditor of the compliance plan for a registered managed investment scheme appointed under s601HG of the Act.

RG 187.66 The rotation requirements apply only to an auditor who *plays a significant role* in the audit of an audited body. Section 9 defines when an auditor plays a significant role in the audit of an audited body. Essentially, a person plays a significant role in the audit of an audited body if they are:

- (a) the lead auditor (see RG 187.68);
- (b) the review auditor (see RG 187.69–RG 187.72); or
- (c) an RCA individually appointed as the auditor of the audited body.

RG 187.67 The rotation requirements do not apply to every person that is involved in the conduct of the audit. A professional member of the audit team is not required to rotate unless that person plays a significant role in the audit of the audited body (i.e. as the individually appointed auditor, lead auditor or review auditor). Although there is no express prohibition in the Act against an RCA who is ineligible to act as the auditor, lead auditor or review auditor having *any ongoing involvement* in the audit (e.g. as a professional member of the audit team), the requirements of the applicable codes of professional conduct (e.g. Standard APES 110 *Code of Ethics for Professional Accountants* (APES 110)), which apply under the auditing standards, must also be considered. APES 110 prohibit a person from *participating* in the audit engagement for not less than 2 years since the end of the financial year following the end of the 5 years service as Lead Engagement Partner, Audit review Partner and/or Engagement Quality Control Reviewer (see para 290.154 of APES 110). We expect that most auditors will be subject to this prohibition.

Note: APES 110 applies to members of CPA Australia and the Institute of Chartered Accountants in Australia (ICAA). A similar prohibition applies to members of the National Institute of Accountants (NIA) under Pronouncement 1: *Code of Ethics* (NIA Code) (see para 290.165 of the NIA Code).

Lead auditors

RG 187.68 The ‘lead auditor’ is the RCA who is primarily responsible to the audit firm or the AAC for the conduct of the audit: s324AF. In most cases this person will be known as the ‘engagement partner’ (see para 8(a) of Auditing Standard ASA 220 *Quality Control for Audits of Historical Financial Information* (ASA 220)). We consider that the ‘engagement partner’ performs the same role as the ‘lead auditor’.

Review auditors

RG 187.69 The ‘review auditor’ is the RCA who is primarily responsible to the individual auditor, the audit firm or the AAC for reviewing the conduct of the audit: s324AF.

RG 187.70 The Act does not require the appointment of a review auditor. However, s307A of the Act provides that the audit of the financial report for a financial year or the audit or review of the financial report for a half-year must be conducted in accordance with the auditing standards. The auditing standards require the appointment of an ‘engagement quality control reviewer’ (EQCR) for audits of listed entities (see para ASA 220.40).

RG 187.71 We do not consider that there is any substantive difference between the roles played by a review auditor conducting a review of the conduct of the audit under the Act and an EQCR conducting a similar review under the auditing standards. However, there is no requirement in the auditing standards that the EQCR be an RCA and, if they are not an RCA, that person will not technically be caught by the rotation requirements.

RG 187.72 Rotation of the EQCR is required under APES 110. For example, APES 110 states ‘using the same Lead Engagement Partner, or Audit Review Partner (if any), or Engagement Quality Control Reviewer on an audit over a prolonged period of time may create a familiarity threat’. If the audited body is a listed entity these people should be rotated after serving in any of these capacities, or a combination thereof, no longer than 5 years within a 7 year period (see para 290.154 of APES 110). APES 110 provides for a time-out period of 2 years.

Note: Failure to comply with APES 110 (where it is relevant) must be included in a declaration made by the auditor under s307C: see RG 187.84–RG 187.85.

Ineligible auditors

RG 187.73 The rotation requirements determine who is eligible to play a significant role in the audit of an audited body. An auditor should not consent to appointment as the auditor of a listed company or listed scheme or act in the role of lead auditor or review auditor if they are not eligible to do so because of the rotation requirements. In the case of an audit firm or AAC, the members of the firm or directors of the AAC should not consent to appointment of the firm or AAC as the auditor if there are no RCAs in the firm or AAC eligible to conduct the audit.

Note: An audit firm or AAC might engage an eligible RCA as a consultant or contractor, if there are no eligible RCAs within the firm or AAC.

RG 187.74 It is the auditor's responsibility to monitor their own eligibility and ensure they are eligible before consenting to an appointment as auditor, engaging in audit activity or playing a significant role in the audit. It is also the auditor's responsibility to advise the audited body if they are ineligible to be appointed or reappointed as the auditor.

Note: If the auditor is ineligible to act as the lead auditor they cannot simply swap roles with the review auditor (or the other way around).

RG 187.75 However, if an auditor has consented to being appointed as the auditor of an audited body for a financial year and has subsequently become aware that they are not eligible to play a significant role in the audit during that financial year, the auditor should resign under s329(5) or 331AC(2). In our view, the audited body may fill the subsequent vacancy as if it were a 'casual vacancy' under s327C or 331AAB.

Note 1: See Regulatory Guide 26 *Resignation of auditors* (RG 26).

Note 2: Resignation of the audit firm or AAC as the auditor of the listed company or listed scheme will be necessary only if no RCA at the firm or AAC is eligible to act as the lead auditor or review auditor and the firm or AAC cannot otherwise provide an eligible auditor (e.g. by engaging a consultant or contractor).

RG 187.76 If an auditor resigns in the circumstances outlined in RG 187.75, the auditor must notify the audited body about the reason for their resignation (s329(5) or 331AC(2)). The auditor will also need to consider whether the breach of the rotation requirements is a contravention that must be reported to us under s311: see RG 187.79–RG 187.83.

What happens if an ineligible auditor plays a significant role in the audit?

RG 187.77 If an auditor plays a significant role in the audit of an audited body when that auditor is not eligible to do so because of the rotation requirements, that auditor has contravened s324DB. If the auditor is acting on behalf of an audit firm or AAC then, in some circumstances, members of the firm (under s324DC), or the AAC and its directors (under s324DD), will be liable for a criminal offence.

Note: The members of the firm or directors of the AAC may be able to rely on a quality control system defence: see s324DC(4) and 324DD(5).

RG 187.78 The validity of an audit will not be affected if an auditor plays a significant role in the audit in breach of the rotation

requirements because contravention of the rotation requirements does not lead to the automatic termination of the auditor's appointment.

Note: This is in contrast to the other auditor independence requirements (see Div 3 of Pt 2M.4), which provide that an auditor ceases to be the auditor of a company where a conflict of interest situation arises, or one of the specific independence requirements has been breached, and the conflict or breach has not been remedied within the period provided in s327B (i.e. 21 days). Similar provisions apply to the auditor of a listed scheme: see s331AAA.

Notifying contraventions

RG 187.79 Section 311 of the Act requires an auditor conducting an audit to report to us if the auditor is aware of circumstances that the auditor has reasonable grounds to suspect amount to a contravention of the Act, where either of the following criteria is satisfied:

- (a) the contravention is 'significant'; or
- (b) the auditor believes that the contravention will not be adequately dealt with by commenting on it in the auditor's report or by bringing it to the attention of the directors.

RG 187.80 There is nothing in s311 that limits the reporting obligation to contraventions of the Act by the audited body. We consider that an auditor must notify us of the auditor's *own* contraventions of the Act, including any contraventions of the time-out rule or the 5/7 rule, if either of the criteria set out above is satisfied.

RG 187.81 The definition of 'significant' in s311(4) expressly directs the auditor to consider:

- (a) the level of penalty provided for in relation to the contravention; and
- (b) the effect that the contravention has, or may have, on:
 - (i) the overall financial position of the company, registered scheme or disclosing entity; or
 - (ii) the adequacy of the information available about the overall financial position of the company, registered scheme or disclosing entity ...'.

Note: See Regulatory Guide 34 *Auditors' obligations: reporting to ASIC* (RG 34).

RG 187.82 A breach of the rotation requirements is a criminal offence carrying a penalty of up to 25 penalty units or imprisonment for 6 months or both. As auditor rotation is a key component of auditor independence, failure to rotate may create a perception that 'the

information available about the overall financial position' of the audited body is inadequate. We consider that a breach of the rotation requirements is highly likely to be a 'significant' contravention that must be reported to us under s311.

RG 187.83 In assessing the significance of a breach, we will also take into account what the breach demonstrates about the auditor rotation compliance measures that the auditor, the audit firm or AAC have put in place.

RG 187.84 In addition, s307C of the Act requires an auditor who has conducted an audit of the financial report or an audit or review of any half-year financial report to make a written declaration (s307C declaration) to the directors of the audited body that includes whether, to the best of the individual auditor's knowledge and belief, there have been any contraventions of:

(a) the auditor independence requirements; or

Note: The definition of 'auditor independence requirements' in s9 expressly includes the rotation requirements.

(b) any applicable codes of professional conduct.

RG 187.85 There is no significance test in s307C. *Any* contravention of the rotation requirements must be included in the auditor's s307C declaration. This declaration must be included in the annual directors' report (see s298(1)(c)) and lodged with us under s319.

Key terms

RG 187.86 In this guide, terms have the following meaning:

5/7 rule The auditor rotation obligation in s324DA(2) of the Act

AAC An authorised audit company registered under Pt 9.2A of the Act

Act *The Corporations Act 2001*

APES A standard issued by APESB

APESB The Accounting Professional and Ethical Standards Board

APRA The Australian Prudential Regulation Authority

ASA 220 Auditing Standard ASA 220 *Quality Control for Audits of Historical Financial Information* (April 2006)

audited body In relation to an audit of a company or registered scheme, means the company or registered scheme in relation to which the audit is, or is to be, conducted

Note: This is a definition contained in s9 of the Act.

auditor rotation The requirements in s324DA of the Act

Audit review Partner Has the meaning given in APES 110

CLERP 9 Act *The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*

CPA Australia The company and business name for the Australian Society of Certified Practising Accountants

engages in audit activity Has the meaning given in s9 of the Act

EQCR An Engagement Quality Control Reviewer

Engagement Quality Control Reviewer Has the meaning given in APES 110

ICAA The Institute of Chartered Accountants in Australia

Lead Engagement Partner Has the meaning given in APES 110

lead auditor The ‘registered company auditor who is primarily responsible to the audit firm or AAC for the conduct of the audit’

Note: This is a definition contained in s324AF(1) of the Act.

listed scheme A listed registered managed investment scheme

NIA The National Institute of Accountants

plays a significant role Has the meaning given in s9 of the Act

RG 51 (for example) A regulatory guide (in this example numbered 51)

RCA A registered company auditor

review auditor The ‘registered company auditor (if any) who is primarily responsible to the individual auditor, audit firm or AAC for reviewing the conduct of the audit’

Note: This is a definition contained in s324AF(2) of the Act.

rotation requirements The time-out rule and the 5/7 rule

s307C declaration A declaration by an individual auditor or lead auditor required to be made to the directors of the audited body under s307C of the Act

time-out rule The auditor rotation obligation in s324DA(1) of the Act.

Related information

RG 187.87

Headnotes

AAC; audited body; audit firm; auditor; authorised audit company; CLERP 9; lead auditor; listed company; listed registered managed investment scheme; RCA; registered company auditor; review auditor; rotation; unreasonable burden

Regulatory guides

RG 26 *Resignation of auditors*

RG 34 *Auditors' obligations: reporting to ASIC*

RG 43 *Accounts and audit relief*

RG 51 *Applications for relief*

Consultation papers

CP 72 *Auditor rotation: ASIC policy proposal* (April 2006)

Legislation

Corporations Act 2001 Pt 2M.4, s298(1)(c), 307C, 311, 319, 323D, 324AF, 324DA, 324DB, 324DC, 324DD, 327B, 327C, 329(5), 331AAA, 331AAB, 331AC(2), 340, 341, 342A, 342B, 601HG; *Insurance Act 1973* s40; *Life Insurance Act 1995* s84

Auditing standards

Auditing standard ASA 220 *Quality control for audits of historical financial information*, Auditing and Assurance Standards Board (April 2006)

Professional codes of conduct

APES 110 *Code of ethics for professional accountants*, APESB (June 2006)

Pronouncement 1 *Code of ethics*, NIA (July 2006)

Cases

Mazda Australia Pty Ltd v Australian Securities Commission (1992) 8 ACSR 613

Directors of Liquid Air (WA) Pty Ltd v Commissioner for Corporate Affairs (1989) 15 ACLR 29