



**Australian Government**

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**The Treasury**

**Parliamentary Joint Committee on  
Corporations and Financial Services:  
inquiry into the regulation of  
auditing in Australia**

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**Submission**

**11 October 2019**

# CONTENTS

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1. Introduction .....	1
1.1 Scope of this submission .....	1
2. The importance of audits and the role of auditors .....	2
2.1 Why audit?.....	2
2.2 Whose reports are audited?.....	3
2.3 What is the auditor’s role? .....	3
3. The legislative and regulatory framework .....	4
4. Overview of the Corporations Law relating to auditing .....	7
4.1 An overview .....	7
4.2 The audit requirement.....	8
4.3 Registration, appointment, removal and resignation.....	8
4.3.1 Registration and appointment.....	8
4.3.2 Removal and resignation .....	10
4.4 Auditor independence .....	10
4.4.1 General independence requirement .....	11
4.4.2 Listed relationships that are treated as non-independent.....	12
4.4.3 Auditor independence declaration.....	12
4.4.4 Mandatory waiting periods for a retiring partner to become an officer of the audited body.....	13
4.4.5 Rotation requirements for listed entities .....	13
4.4.6 Provision of non-audit services .....	14
4.5 Auditors’ duties.....	14
4.5.1 Reporting obligations .....	14
4.5.2 Duties to the company .....	16
4.5.3 Audit committees and directors’ duties .....	17
4.6 Auditor’s liability.....	18
4.6.1 Auditor offences .....	18
4.6.2 Auditor’s liability to a company.....	19
4.6.3 Indemnification of an auditor from liability .....	19
4.6.4 Auditor’s liability to third parties.....	19
Attachment A – Auditor related offences .....	21

# 1. INTRODUCTION

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This submission responds to the Terms of Reference for the inquiry of the Parliamentary Joint Committee on Corporations and Financial Services (the Committee) into the Regulation of Auditing in Australia.

Audit is an important component of Australia's financial reporting framework. The framework is designed to provide investors in Australian firms with accurate and useful information about companies' business activities and financial position. This in turn supports the efficiency of Australia's capital markets by allowing market participants to allocate capital to its most productive use – a vital prerequisite for strong economic growth.

Treasury is pleased to provide assistance to the committee by providing an overview of the current legislative framework for auditing in Australia.

## 1.1 Scope of this submission

The terms 'audit' and 'auditor' have a variety of meanings and there are many situations in which they are applied. A 2014 study that reviewed Commonwealth and State statutes and regulations found that there were 222 Acts identified that required the performance of an audit but did not stipulate who would carry out the audit, 101 other Acts that used unique terms to describe who the nominated auditor could or should be, 137 Acts that required a registered company auditor to perform an audit, and 81 Acts that required a registered company auditor *or* another person (usually a member of a professional accounting body) to perform the audit.<sup>1</sup>

This proliferation of audit requirements reflects a widespread public and private demand for auditing and assurance services. Covering each of these audit types is beyond the scope of this submission. In accordance with the Committee's request to Treasury and the overall focus of the inquiry, this submission will focus on registered company auditors' audits of companies' financial reports as set out in Chapter 2M of the *Corporations Act 2001* (Corporations Act). Accordingly, the terms 'audit', 'auditor', 'company', and 'financial report' will have particular and consistent meanings throughout this submission. These are outlined below in Box 1.

This submission will focus on the legislative framework for auditing. It will provide a detailed explanation of the content of the law, summarise the economic function of the financial reporting and audit framework, the role of auditors, and provide a brief history of law reform related to auditors. A summary table of auditor-related offences in the Corporations Act is also included at Attachment A.

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<sup>1</sup> Bessell, M., Powell, L and Richardson, G. 2014, *The Demand for Registered Company Auditor Services in Australia*, CAANZ.

**Box 1: Terms used in this submission**

Unless otherwise described or implied, terms used in this submission have the following meanings:

**Audit** means an audit of a financial report required by Chapter 2M of the Corporations Act and conducted in accordance with that chapter.

**Auditor** means a registered company auditor, which is the designated auditor for audits of financial reports under Chapter 2M of the Corporations Act. A registered company auditor may be an individual, an audit firm (partnership) or an audit company. It denotes the person who undertakes the audit and signs the auditor's report.

**Company** means an entity that is required to have its financial report audited under Chapter 2M of the Corporations Act.

**Financial report** means an annual financial report or a half-year financial report prepared under Chapter 2M.

All references to legislation in this submission are references to the *Corporations Act 2001* unless otherwise indicated or implied.

## 2. THE IMPORTANCE OF AUDITS AND THE ROLE OF AUDITORS

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### 2.1 Why audit?

Australia's financial reporting system aims to ensure the market has appropriate, useful information to make efficient and effective decisions about the allocation of resources.

In Australia capital is allocated by the market. Markets require adequate information to function efficiently. Investors require accurate, relevant, and comparable information to make decisions about which investments suit them best, and how much they should invest. This applies whether investors are entities or individuals, with large or small amounts of capital at their disposal.

These decisions will collectively determine how capital is allocated in the economy. If capital is directed towards productive firms, the economy will grow more quickly. If capital is misdirected to less productive firms, the economy will not grow as quickly as it otherwise would.

To ensure that information published by firms is accurate, relevant, and comparable, firms must publish financial reports according to accounting standards set by the Australian Accounting Standards Board (AASB). These standards set out what is to be included in a financial report, and how information and amounts should be calculated and presented.

These reports must be audited by an individual auditor to provide assurance that they are accurate and that the company has not misrepresented itself (either intentionally or unintentionally).

Audit is therefore one element of a broader financial reporting system, but it is significant because it constitutes the principal independent, external check on the integrity and reliability of companies' financial reporting. It adds credibility to the financial statements prepared by companies, increasing shareholders' and other users' confidence in them.

## 2.2 Whose reports are audited?

All public companies and large propriety companies must provide an audited financial report. Most small propriety companies are exempt from these obligations, except those that are foreign-controlled or use crowd-sourced funding arrangements. A small proprietary company can still appoint an auditor and have its financial report prepared and audited if it is directed to do so by either the Australian Securities and Investment Commission (ASIC) or shareholders holding at least 5 per cent of the votes. The Government recently increased the thresholds that define the boundary between large and small proprietary companies (see Box 2).

These differing requirements acknowledge the need to balance costs borne by the company to produce the financial report and have it audited, with the benefits that are derived from providing accurate information to the market. Independently assured financial reports provide broad-ranging benefits to investors, related parties, the broader market, and to firms themselves (by making it easier to obtain capital).

### Box 2: Raising the threshold for large proprietary companies

Proprietary companies are considered to be 'large' (and subject to audit and reporting requirements) if they meet at least two of the following thresholds for a given financial year:

- \$50 million or more in consolidated revenue.
- \$25 million or more in consolidated gross assets.
- 100 or more employees.

Each threshold was recently doubled, effective for financial years beginning on or after 1 July 2019. This followed a Government commitment to reduce the reporting burden for small and medium sized businesses.

The threshold changes aim to ensure that reporting requirements are targeted at larger, more economically significant companies. The current thresholds had not been reviewed since 2007 and no longer reflected the level at which a company becomes economically significant.

The threshold changes mean that around one third of proprietary companies would no longer be required to lodge financial reports with ASIC. This is estimated to reduce the regulatory cost on these businesses by \$81.3 million per annum.

## 2.3 What is the auditor's role?

The role of the auditor is to form an opinion about the financial report of a company. The auditor's report states whether, in the opinion of the auditor, the financial report is in accordance with the Corporations Act, including complying with Australian accounting standards and providing a true and

fair view of the state of affairs and activities of the company.<sup>2</sup> The auditor must comply with the auditing standards issued by the Australian Auditing Standards Board (AUASB) when performing the audit.<sup>3</sup>

To enable an opinion to be formed, the auditor gathers audit evidence. The auditor reviews accounting treatments and estimates used in preparing the financial statements, and the measurement and disclosure of balances and material transactions.

Auditors are required to form an opinion on the basis of obtaining reasonable assurance (not absolute assurance) that the financial report as a whole is free from material misstatement. Accordingly, the auditor's opinion does not provide a guarantee or assure the future viability of the company, nor the efficiency or effectiveness with which management has conducted the affairs of the company.

### 3. THE LEGISLATIVE AND REGULATORY FRAMEWORK

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Audit in Australia is governed and regulated by a framework of legislation, standards, regulators, disciplinary boards, and professional bodies (see Diagram 1).

The Corporations Act is the primary legislation from which the framework is derived.<sup>4</sup> It sets out a number of specific requirements for financial reporting, the auditor function, and the performance of that function. It delegates the creation and maintenance of accounting standards to the AASB, and auditing standards to the AUASB, but the Act explicitly mandates compliance with these standards.

ASIC is responsible for regulation and enforcement of the financial reporting and audit requirements of the Corporations Act. ASIC supervises entities' compliance with these requirements, the conduct of auditors, and auditors' compliance with the requirements of the Corporations Act. ASIC may take enforcement action against individual auditors where non-compliance with the Corporations Act or auditing standards is identified. This can include applying to the Companies Auditors Disciplinary Board (CADB) to have an auditor deregistered, or making an application to a court for a civil or criminal penalty where applicable.

The *Australian Securities and Investments Commission Act 2001* (ASIC Act) creates the statutory bodies that are responsible for developing standards and ensuring compliance with the Corporations Act. These bodies are the Financial Reporting Council (FRC), the Australian Accounting Standards Board (AASB), the Auditing and Assurance Standards Board (AUASB), the Companies Auditors Disciplinary Board (CADB), and the Australian Securities and Investments Commission (ASIC).

The roles of these entities are summarised in Box 3 but detailed explanation of the standard setting, oversight, regulation, and disciplinary work of the ASIC, AUSAB, FRC, CADB, and professional bodies is outside the scope of this submission.

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<sup>2</sup> s 307

<sup>3</sup> s 307A

<sup>4</sup> The majority of relevant provisions in the *Corporations Act* are found in Divisions 3, 4 and 5 of Part 2M.3, Divisions 3, 4 and 5 of Part 2M.4

**Box 3: Statutory bodies responsible for developing standards and ensuring compliance with the Corporations Act**

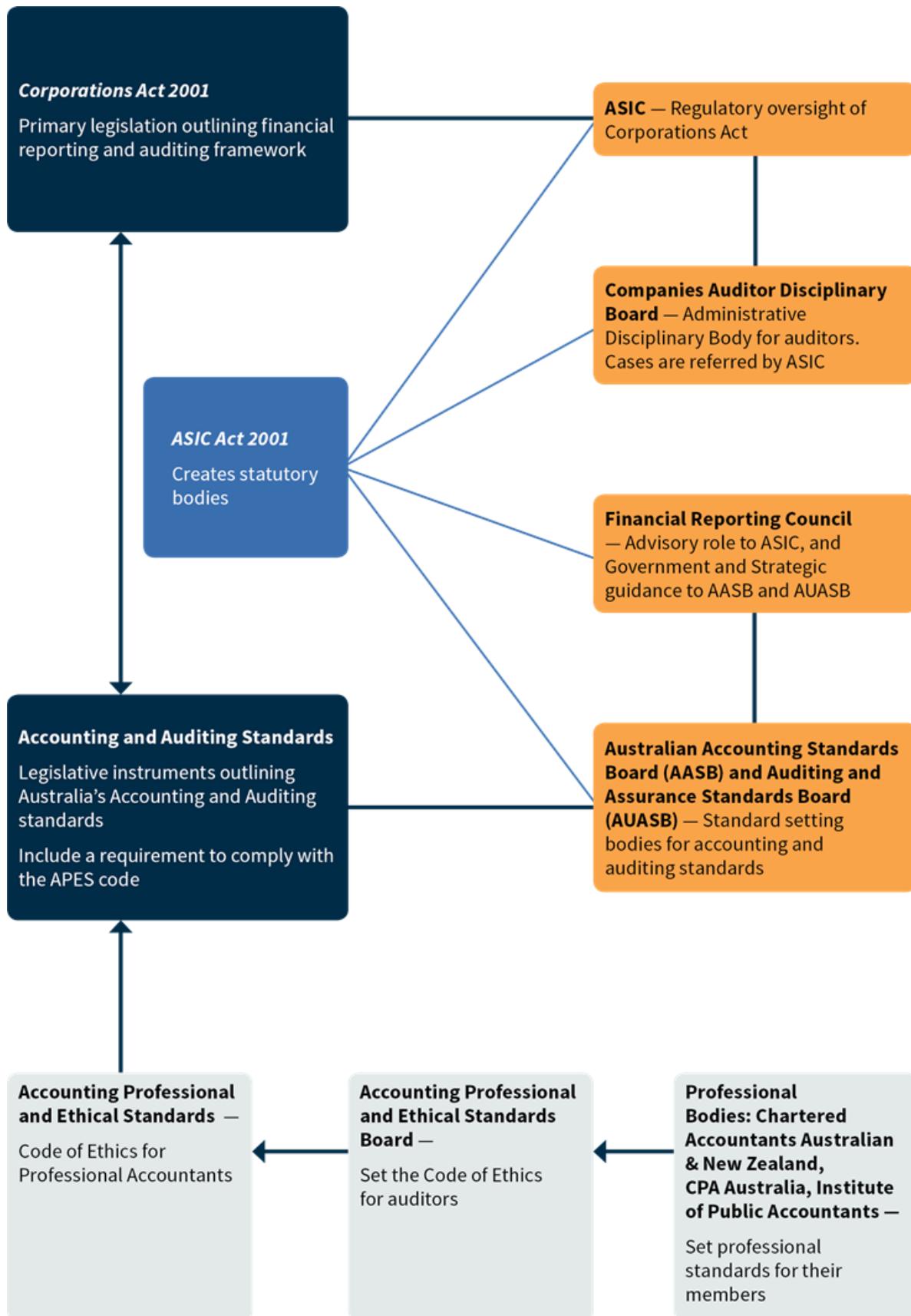
The CADB is an independent statutory body whose key function is as an administrative disciplinary body for auditors registered by ASIC under the Corporations Act. Following an application being made to CADB by ASIC or the Australian Prudential Regulation Authority (APRA), CADB performs the role of an independent decision maker and, if necessary, makes orders including cancelling or suspending the registration of an auditor. CADB reviews evidence and holds hearings to inform its decisions.

The FRC is an advisory body that oversees the accounting and auditing standards processes and provides strategic guidance to the AASB and AUASB, and strategic advice to Government and ASIC. The FRC does not have the ability to direct that standards be set in a particular way. Prior to 2012, the FRC was tasked by legislation to oversee auditor independence. In 2012, the FRC's independence mandate was replaced by a mandate to oversee audit quality in Australia.

The AUASB is an independent standard-setting body that sets Australian auditing and assurance standards based on International Standards issued by the International Auditing and Assurance Standards Board (IAASB). The AASB is an independent standard-setting body that sets Australian Accounting Standards.

Professional accounting associations also represent auditors, and play a role in upholding standards in the industry. These bodies do not have a role that is referenced in legislation, although the Accounting Professional & Ethical Standards Board (a joint venture of the three professional accounting bodies) maintains a code of ethics that is referenced in AUASB standards.

Diagram 1: Overview of the financial reporting framework



## 4. OVERVIEW OF THE CORPORATIONS LAW RELATING TO AUDITING

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### 4.1 An overview

Chapter 2M of the Corporations Act sets out a comprehensive legislative framework for financial reporting and auditing in Australia, including requiring companies to prepare reports, have them audited, and submit them to ASIC.

The Act requires that financial reports and audits comply with the accounting and auditing standards, requires auditors to give a true and fair view of the financial position of the company, and establishes a scheme for regulating 'registered company auditors' in Australia (referred to simply as 'auditors' in this submission).

Auditors on whom ASIC confers registration must continuously comply with the relevant requirements of the Corporations Act, including continuously maintaining proper professional standards when performing audit duties and functions, and maintaining fitness and propriety at all times in order to retain their registered status.

The Act also sets out requirements for auditor independence to address conflicts of interest, and sets out sanctions for contraventions of the Act.

#### Box 4: History of law reform relating to auditors

CLERP 9 implemented a number of recommendations made by the *Independence of Australian Company Auditors* (Ramsay Report) in 2001, the Joint Committee of Public Accounts and Audit's Report 391 *Review of Independent Auditing by Registered Company Auditors* in 2002, and the HIH Royal Commission in 2003.

CLERP 9 made compliance with auditing standards issued by the AUASB a legal requirement and introduced a number of provisions in the Corporations Act strengthening independence requirements for auditors.

Other audit-related amendments were made to the Corporations Act in 2007 and in 2012. In 2007, the *Australian Securities and Investments Commission Amendment (Audit Inspection) Act 2007* enhanced ASIC's audit inspection powers and enabled its greater co-operation with international audit regulators.

In the same year, the *Corporations Legislation Amendment (Simpler Regulatory System) Act 2007* shortened the mandatory waiting periods for retired members of audit firms and certain retired professional employees of audit companies wanting to take up a position with an audited body (ss 324CI and 324CJ respectively).

In 2012, the *Corporations Legislation Amendment (Audit Enhancement) Act 2012* introduced a requirement for certain auditors to prepare an annual transparency report to improve audit quality by enhancing the transparency of audit firms.

ASIC has discretion to grant relief from the financial reporting provisions in the Corporations Act to a company, registered scheme or disclosing entity, its directors, and/or its auditor.<sup>5</sup> This relief can only be granted if certain statutory preconditions are satisfied. Even if they are satisfied, ASIC has an overriding discretion to decline the relief.<sup>6</sup>

The most substantial set of law reforms relating to audit since the turn of the century was the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9) which introduced a range of measures designed to enhance audit regulation (see Box 4).

## 4.2 The audit requirement

Section 301 of the Corporations Act requires companies to have their annual financial statements audited and to obtain an auditor's report.<sup>7</sup> As discussed earlier in section 2, small proprietary companies and certain companies limited by guarantee are not subject to this requirement.<sup>8</sup>

## 4.3 Registration, appointment, removal and resignation of auditors

### 4.3.1 Registration and appointment

A company or a registered scheme may appoint an individual, or a firm, or a company as its auditor (see Box 5).<sup>9</sup> Auditors of companies must be registered as such by ASIC. To ensure that prospective auditors are capable and competent, they must meet certain conditions relating to education, experience/competency and integrity (i.e. being a fit and proper person) in order to be registered. See Box 6 for more detail on education and experience.<sup>10</sup> If these conditions are met, ASIC must grant the application and register the applicant as an auditor.

Once registered, an auditor has legislative authority to audit companies in Australia. ASIC manages the registration and supervision (including investigations) of auditors. ASIC may cancel registration at the request of the auditor.<sup>11</sup> The CADB can cancel or suspend the registration of an auditor against his or her will on the application of ASIC or APRA, following relevant hearings and procedures.<sup>12</sup>

Generally, an auditor of a public company is appointed at the Annual General Meeting (AGM). For public companies which are newly formed, the first auditor must be appointed by the directors within one month after incorporation of the company unless the AGM has done so. This initial auditor holds office until the company's first AGM.<sup>13</sup> At the first AGM, an auditor is appointed and any vacancy in

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<sup>5</sup> Relief is for the requirements of Pts 2M.2, 2M.3 and 2M.4 (other than Div 4) of the Corporations Act.

<sup>6</sup> s 341

<sup>7</sup> s 301(1)

<sup>8</sup> The circumstances under which those small proprietary companies that are required to prepare a financial report and are not required to have their financial report audited are specified in s 301(2). A company limited by guarantee may have its financial report reviewed rather than audited if it is not a Commonwealth entity specified in s 301(3)(a) and its revenue (or consolidated revenue, in the case of a consolidated entity) is less than \$1 million. Companies limited by guarantee with an annual turnover of \$1 million or more are required to have financial reports audited (s 301(b)). A small company limited by guarantee is not required to have its financial report either audited or reviewed if that is required by a member direction under s 294A, if that direction does not ask for an audit or review (s 301(4)).

<sup>9</sup> s 324AA for the appointment and s 9 for definitions of audit firm and audit company.

<sup>10</sup> s 1280

<sup>11</sup> s 1290

<sup>12</sup> s 1292

<sup>13</sup> s 327A

the office of auditor is to be filled at subsequent AGMs.<sup>14</sup> In case of a proprietary company the directors may appoint an auditor if one has not been appointed by the members in the general meeting.<sup>15</sup>

**Box 5: Types of auditors**

The Corporations Act recognises that the persons or entities who are eligible to be appointed as an auditor of a company or registered scheme are an individual, a firm (partnership) or a company (authorised audit company). A person may be found guilty of an offence if she or he consents to be a company's auditor and acts as an auditor without being registered (s324BA). The registration process for each of these persons or entities are different, and is as follows:

(i) Individual auditor — Individual auditors must be formally registered with ASIC under Part 9.2. To be registered, an individual must have the necessary qualifications, skills, and be a capable, fit and proper person.

(ii) Audit Firm (partnership) — Audit firms do not need to be formally registered with ASIC, but at least one member of the firm must be a registered company auditor. If a company appoints an audit firm as its auditor then all of the registered company auditors who are members of the firm are treated as auditors of the company (ss 324AB, 324AC, 324BB).

(iii) Authorised audit company (corporate) — Authorised audit companies must be formally registered with ASIC under Part 9.2A (s 324BC). Registration of an authorised audit company requires that each of the directors of the company must be a registered company auditor, that the company be controlled and majority-owned by registered company auditors and that it have adequate and appropriate professional indemnity insurance (s 1299B). All the reports and notices are given on behalf of the company by a director, or the lead auditor or review auditor for the audit (s 324AD).

**Box 6: Requirements for auditors relating to education and competency**

Section 1280(2A) states that an applicant for registration as an auditor must:

- hold a degree, diploma or certificate from a prescribed university or another prescribed institution in Australia; and
- have, in the course of obtaining this degree, diploma or certificate, passed examinations in such subjects, under whatever name, as the appropriate authority of the university or other institution certified to ASIC to represent a course of study
  - in accountancy (including company law) of not less than 3 years duration; and
  - in commercial law (including company law) of not less than 2 years duration; and
- have satisfactorily completed a course in auditing prescribed by the regulations for the purpose of this paragraph.

Section 1280(2B) allows an applicant for registration as an auditor to have other qualifications and experience than described by section 1280(2A) if ASIC is satisfied that they are equivalent to the requirements in section 1280(2A).

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<sup>14</sup> s 327B

<sup>15</sup> s 325

### 4.3.2 Removal and resignation

An auditor is appointed until resignation, removal, death, or otherwise ceasing to be an auditor.<sup>16</sup> An auditor ceases to hold office if they inform ASIC of a conflict of interest situation in relation to a company and the situation is not resolved within one month.<sup>17</sup> An auditor also ceases to be appointed after a company goes into liquidation.<sup>18</sup>

To give the directors of the company and users of audited financial reports certainty over the continuity of the audit function, the Corporations Act provides for orderly ways of removing auditors and for auditors to cease their role as auditor of a particular company.

#### Removal

If shareholders are unhappy with an auditor's performance, they may remove the auditor by resolution of the company in the AGM if special notice is given.<sup>19</sup>

The directors do not have the power to appoint a new auditor if the members in the AGM resolve to remove the auditor. This provides a safeguard for company members to ensure an independent audit may be conducted in instances where this may not align with the interests of management. In this case, a new auditor may be immediately appointed by shareholders through a special resolution, provided that a notice of nomination has been given to the proposed new auditor. If such a resolution is not passed or a notice of nomination is not given, the auditor may be appointed at an adjourned meeting by an ordinary resolution on nomination provided by any shareholder of the company.<sup>20</sup> If a public company is in this position and fails to appoint a new auditor through this process, then ASIC must appoint an auditor.<sup>21</sup>

#### Resignation

Auditors who wish to resign as the auditor of a particular company must apply to ASIC for consent to resign, stating the reasons. The auditor must notify the company in writing of the application and, if ASIC gives its consent, the auditor may resign after giving the company written notice.<sup>22</sup> The resignation of an auditor of a proprietary company or a small company limited by guarantee does not require ASIC consent.<sup>23</sup>

## 4.4 Auditor independence

Auditor independence is fundamental to the credibility and reliability of auditor's reports and therefore to the credibility and reliability of audited financial statements. To be credible to users, the auditor's report must be based on an objective, disinterested assessment of the financial statements, free from any conflict of interest.

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<sup>16</sup> s 327B(2)

<sup>17</sup> ss 327B(2A), 327(2B), 327(2C)

<sup>18</sup> s 330

<sup>19</sup> s 329

<sup>20</sup> s 327D

<sup>21</sup> s 327E

<sup>22</sup> s 329 (5)

<sup>23</sup> s 329(9)

CLERP 9 introduced a number of amendments to the Corporations Act aimed at strengthening auditors' capacity to act independently and to exercise objective and impartial judgment when conducting an audit.

The amendments included a general auditor independence requirement which defined a 'conflict of interest' situation. This general auditor independence requirement is supplemented by a non-exhaustive list of relationships that are treated as non-independent. While the general independence requirement covers all conflict of interest situations, the list is included in the legislation to place it beyond doubt that those named relationships are prohibited.

The Act also requires auditors to make an annual independence declaration and complete a mandatory waiting period requirement before joining an audit client as a director or senior manager. The Act also mandates a rotation requirement for auditors and requires directors to disclose the fees paid to their auditor for non-audit services and the nature of such services in the directors' report to shareholders. These requirements are detailed in the section below.

The independence requirements of the Corporations Act are supplemented by independence requirements of the Australian auditing standards and Accounting Professional and Ethical Standards Board's (APESB's) *110 Code of Ethics for Professional Accountants*.<sup>24</sup>

#### 4.4.1 General independence requirement

The Corporations Act sets out the general requirements for auditor independence for individual auditors, audit firms, and audit companies. An individual auditor, an audit firm or an audit company breaches the independence requirements if the following conditions are met:

- they engage in audit activity in relation to an audited body at particular time; and
- a 'conflict of interest situation' existed in relation to the audited body at that time; and
- they are aware that the conflict of interest situation existed at that time; and
- they did not, as soon as possible after becoming aware, take all reasonable steps to ensure that the conflict of interest situation ceased to exist.<sup>25</sup>

If they are not aware of the existence of the conflict of interest situation, an individual auditor, an audit firm or an audit company is liable unless they had reasonable grounds to believe that a quality control system had been in place, and that this control system provided reasonable assurance that a conflict would not occur.<sup>26</sup>

The Corporations Act defines the term 'conflict of interest situation' for the purpose of the general independence requirements. The conflict of interest situation is taken to exist in relation to an audited body if:

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<sup>24</sup> Auditing standard ASQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements; and Auditing Standard ASA 220 Quality Control for an Audit of a Financial Report and Other Historical Financial Information.

<sup>25</sup> ss 324CA, 324CB and 324CC respectively

<sup>26</sup> ss 324CA(2), (4) and (5)

- the auditor or a professional member of the audit team is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body; or
- a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor or a professional member of the audit team is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.<sup>27</sup>
- Without limiting these provisions, regard must be had to any relationship between:
  - the individual auditor; or the audit firm or any current or former member of the firm; or the audit company, any current or former director of the audit company or any person currently or formerly involved in the management of the audit company; and
  - the audited company or its current or former directors or persons currently or formerly involved in its management.<sup>28</sup>

#### 4.4.2 Listed relationships that are treated as non-independent

In addition to the general requirement for independence, the Corporations Act includes a non-exhaustive list of relationships that are treated as non-independent. These provisions are contravened when an individual is aware of the existence of these relationships, regardless of whether they are not aware of the existence of a related 'conflict of interest situation'.<sup>29</sup>

Section 324CH1 of the Corporations Act identifies the specific auditor independence requirements applicable to certain persons. The relationships are broadly categorised as those relating to employment relationships and financial relationships. In its present form, the Act lists eighteen different relationships.<sup>30</sup>

The restrictions on employment relationships are not applicable to small proprietary companies.

#### 4.4.3 Auditor independence declaration

An individual auditor, or the lead auditor in the case of an audit firm or audit company, must sign a written declaration of auditor independence and provide it to the directors of the audited entity. This declaration is a means of assuring that the auditor is complying with the general requirement to be independent. Failure to provide a written declaration of independence is a strict liability offence.<sup>31</sup>

The declaration states that to the best of the individual auditor's knowledge or belief there have been no contraventions of the auditor independence requirements in relation to the audit or review and no contraventions of any applicable code of professional conduct.

Not all contraventions of independence requirements disqualify an auditor from performing audits for a particular company. Where minor contraventions exist, it is sufficient that these are declared in the independence declaration so that all concerned parties are made aware.<sup>32</sup> The declaration does not

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<sup>27</sup> s 324CD(1)

<sup>28</sup> s 324CD(2)

<sup>29</sup> ss 324CE, 324CF, 324CG and 324CH(1)

<sup>30</sup> s 324CH1

<sup>31</sup> ss 307C(2) and 307C(4)

<sup>32</sup> ss 307C(1) and (3)

need to include inadvertent breaches of the auditor independence requirement, where a statutory defence applies.<sup>33</sup>

The declaration is signed and provided either together with the auditor's report or, if certain conditions are met, before the auditor's report is signed.<sup>34</sup> In addition to the declaration of independence, the auditor's report also includes a statement that the auditor is independent of the entity in accordance with the requirements of the Corporations Act and the ethical requirements of the APESB's *APES 110: Code of Ethics for Professional Accountants*.

#### 4.4.4 Mandatory waiting periods for a retiring partner to become an officer of the audited body

Mandatory waiting periods for retiring partners (or directors) of audit firms (or companies) were introduced into the Corporations Act by CLERP 9. To further strengthen auditor independence (and avoid situations where former members of the audit team could be seen as exerting influence over current auditors) the Corporations Act includes provisions preventing certain individuals from taking up a position with an audited body within a period of two years after the date of the last audit in which the individual participated.

Small proprietary companies are exempt from this restriction. If the audited body is a listed entity, the restriction extends to becoming an officer of any related body corporate of the audited body.<sup>35</sup>

The Corporations Act also prohibits any more than one former partner of an audit firm or director of an audit company becoming an officer of an audited body or related entity within a five-year period after ceasing to be a partner or a director of the audit firm or company.<sup>36</sup>

This applies to retired members of audit firms, retired directors of audit companies and certain retired professional employees of audit companies. The provisions are meant to strike a balance between promoting the auditor's independence while not unnecessarily preventing audit professionals from joining companies and contributing their expertise.

#### 4.4.5 Rotation requirements for listed entities

The Corporations Act imposes auditor rotation requirements. An individual auditor or, in the case of an audit firm or audit company, a person who is appointed as lead auditor or review auditor, is considered to 'play a significant role' in the audit of a company.<sup>37</sup> Individuals that 'played a significant role' in the audit of a listed entity may not lead an audit or review of a company for more than five consecutive years, or in more than five out of seven successive financial years.

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<sup>33</sup> s 307C (5B). The statutory defence to independence requirement is available under ss 324CE(4), 324CF(4) or 324CG(4)

<sup>34</sup> s 307C(5). These conditions, specified by 307C(5A), include: a requirement that the directors sign their report within seven days after being given the auditor's independence declaration; the auditor's report on the financial report is made within seven days after the director's report is signed; and the auditor's report includes a statement that the declaration would be in the same terms if had been given to the directors at the time the auditor's report was made, or setting out how circumstances have changed and the impact of these changed circumstances on the independence declaration. The auditor's independence declaration is included in the director's report so that it is transparent to all users of the financial report

<sup>35</sup> ss 324CI and 324CJ

<sup>36</sup> s 324CK

<sup>37</sup> ss 324DA(1) and 324DA(2)

The rotation requirements were introduced by CLERP 9 to ensure that audit partners do not remain with their clients for significant periods of time, which could compromise their independence.

The directors of a listed company can extend their auditor's rotation period for up to an additional two years by resolution.<sup>38</sup> ASIC can also grant relief from the rotation requirement where there is an unreasonable burden on the auditor (or audit firm) and/or the audited body.<sup>39</sup>

#### 4.4.6 Provision of non-audit services

The HIH Royal Commission and the Ramsay report noted that auditor independence could also be compromised if the auditor provides non-audit services to the company.<sup>40</sup> In response to these concerns the Corporations Act requires listed companies to disclose non-audit services provided by the auditor, and the fees paid for these services.

In particular, the Corporations Act requires that the annual directors' report includes details of the amount paid or payable to the auditor for non-audit services provided during the year, a statement of whether the directors are satisfied that the provision of non-audit services by the auditor is compatible with the general standards of independence imposed by the Corporations Act, and a statement of the directors' reasons for being satisfied that the provision of non-audit services by the auditor did not compromise the auditor independence requirements of the Corporations Act.<sup>41</sup>

Accounting standards also impose a requirement on auditors to disclose the nature of non-audit services and relevant fees received in the company's financial statements.<sup>42</sup>

### 4.5 Auditors' duties

Auditors must fulfil certain duties, some of which are provided for in the Corporations Act, and some of which are derived from common law.

Auditors registered by ASIC must continuously comply with relevant requirements of the Corporations Act in order to retain their registered status. Those requirements include continuously maintaining proper professional standards when performing audit duties and functions and maintaining fitness and propriety at all times.<sup>43</sup>

#### 4.5.1 Reporting obligations

To enhance the transparency and accuracy of financial reports and statements, auditors have a statutory duty to report the results of the audit to the shareholders.

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<sup>38</sup> s 324DAA(1)

<sup>39</sup> s 342A. The circumstances where ASIC may grant relief from the rotation requirements are set out in Regulatory Guide RG 187 Auditor Rotation

<sup>40</sup> Ian Ramsey, 2001, *Independence of Australian Company Auditors*; and HIH Royal Commission, 2003, *Report of the Royal Commission into HIH Insurance*

<sup>41</sup> s 300(11B)

<sup>42</sup> Accounting Standard AASB 1054 *Australian Additional Disclosures*

<sup>43</sup> s 1292

## Auditor's reports

An auditor must report to shareholders whether, in the auditor's opinion, the financial report of a company is compliant with the Corporations Act and the accounting standards.<sup>44</sup> If the auditor forms a view that the financial report *does not* comply with an accounting standard, the auditor's report must quantify the effect of this non-compliance and if that is not possible, the auditor has to explain why.<sup>45</sup> The auditor must also explain the non-compliance, or any other irregularity in the financial reports, in the auditor's report.<sup>46,47</sup>

## Audit of debenture issuers and guarantors

In the case of a company that is a borrowing corporation, the auditor must give the trustee for debenture-holders a copy of the auditor's report within seven days of giving the original to the borrowing corporation.<sup>48</sup> Additionally, the auditor must give the borrowing company or a guarantor a written report about any matters that in her or his opinion are likely to be prejudicial to the interests of debenture holders or relevant to the exercise of the powers of the trustee for debenture-holders.<sup>49</sup>

## Reporting to ASIC

If, during the course of the audit, the auditor has reasonable grounds to suspect that a significant contravention of the Corporations Act has occurred or an attempt has been made to unduly influence, coerce, manipulate or mislead the person involved in the conduct of the audit or otherwise interfere with the proper conduct of the audit, the auditor has a statutory duty to report this to ASIC.

The auditor must notify ASIC as soon as practicable (in any case within 28 days) after she or he becomes aware of those circumstances. Where the matter is not significant and is effectively dealt with by drawing the matter to the attention of the directors or by comment in the auditor's report the auditor does not have to notify ASIC.

If an auditor has reasonable grounds to believe there was a non-significant contravention of the Corporations Act and that the matter has not been or will not be adequately dealt with by commenting on it in the auditor's report or by bringing the matter to the notice of directors, the auditor is required to report the matter to ASIC.<sup>50</sup>

## Annual transparency report

Certain auditors are required to prepare an annual transparency report. This requirement was introduced into the Corporations Act by the *Corporations Legislation Amendment (Audit Enhancement) Act 2012* to enhance the transparency of audit firms that audit a large number of commercially

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<sup>44</sup> s 308(1)

<sup>45</sup> s 308(2)

<sup>46</sup> s 308(3)

<sup>47</sup> Similarly, under s 302, an auditor of a disclosing entity must conduct an audit or 'a review' of the disclosing entity's half-year financial report. When conducting the audit, the auditor must report to shareholders whether in her or his view the report is in accordance with the Corporations Act and is in accordance with the accounting standards (s 309(1)). If in the course of the audit, the auditor becomes aware of any matters that make her or him believe that the half-year financial audit does not comply with the reporting requirements set out by the Corporations Act, he or she must report it to the members (s 309 (4)).

<sup>48</sup> s 313(1)

<sup>49</sup> s 313(2)

<sup>50</sup> s 311

significant companies. This requirement applies to an auditor who in a period of 12 months starting on 1 July conducted an audit of 10 or more listed companies or listed registered schemes, authorised deposit taking institutions within the meaning of the *Banking Act 1959*, and certain other bodies, including bodies prescribed by the regulations.<sup>51</sup>

The report must be published on the auditor's website within four months after the end of the year.<sup>52</sup> The copy of the report must be lodged with ASIC on or before the day it is first published on the auditor's website.<sup>53</sup> The content of the report is prescribed by the regulations.<sup>54</sup> If ASIC considers that complying with the requirement to prepare or publish the transparency report is inappropriate or imposes unreasonable burden, it can exempt the auditor from it.<sup>55</sup>

### Attendance at annual general meetings (AGMs)

Auditors of listed companies must attend the company's AGM at which the audit report for the company is considered. Failure to do so is a strict liability offence.<sup>56,57</sup>

The requirement to attend a company's AGM was introduced by CLERP 9 to maximise shareholders' opportunity to ask the auditor questions relevant to the audit and in this way promote the independence and accountability of auditors. Auditors of unlisted public companies are entitled to attend the AGM and be heard at the meetings on any matters that concern them in their capacity as auditors, however, their participation is not compulsory.<sup>58</sup>

### 4.5.2 Duties to the company

On appointment, an auditor enters into a contractual relationship with the company. If no special express terms are attached, and the auditor is appointed to conduct the audit required by the Corporations Act, the implied terms are that the auditor:

- forms an opinion as to whether the financial statements are drawn in accordance with the Corporations Act and accounting standards and whether they present a true and fair view of the financial position and performance of the company;<sup>59</sup>
- conducts an audit in accordance with the auditing standards;<sup>60</sup>
- reports his or her opinion to shareholders;<sup>61</sup>
- meets independence requirements;<sup>62</sup> and

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<sup>51</sup> ss 332 and 332A(1)

<sup>52</sup> s 332A(2)

<sup>53</sup> s 332A (3)

<sup>54</sup> s 332B, Regulation 2M.4A.02 and Schedule 7A of the Regulations

<sup>55</sup> ss 332D and 332F

<sup>56</sup> s 250RA(1) (2)

<sup>57</sup> Strict liability offence is a standard of liability under which a person is legally responsible for the consequences flowing from an activity even in the absence of fault or criminal intent on the part of the defendant.

<sup>58</sup> s 249V

<sup>59</sup> s 307

<sup>60</sup> s 307(A)

<sup>61</sup> ss 308, 309, 313

<sup>62</sup> ss 324CA, 324CB, 324CC, 324CE, 324CF, 324CG, 324CH and 307C

- uses a reasonable degree of care and skill in the conduct of the audit and in making the report.

#### Duty to use reasonable care and skill

An auditor has legal obligations to apply reasonable care and skill when conducting an audit and forming an opinion on a company's financial report. This helps ensure that auditors meet expectations of competence held by the public. The standards of reasonableness depends on specific circumstances and may be affected by current professional practice norms and/or community expectations.

The auditing and accounting and standards, APESB codes, and legislative requirements in force at the relevant time may be used as minimum requirements of what the proper auditing practice should be evaluated against. A finding of failure to meet such standards may be interpreted by a court as demonstrating failure to exercise a degree of care and skill that should reasonably be expected of an auditor.<sup>63</sup>

#### 4.5.3 Audit committees and directors' duties

While audit committees are considered a key component of many companies' corporate governance structures, these committees are not mandated by the Corporations Act. However, the ASX Listing Rules impose this obligation on listed companies in the S&P ASX All Ordinaries. For companies listed in the top 300 firms in the index by market capitalisation, the rules require the audit committee to consist of at least three members, all of whom are non-executive directors and a majority of whom are independent directors. The audit committee must be chaired by an independent director who is not chairperson of the board.<sup>64</sup>

The main role of the committee is to assist the board of directors in its oversight responsibilities in areas such as an entity's financial reporting, internal control systems, risk management systems and the internal and external audit functions.

The committee is established by the board of directors as a sub-committee and its powers are delegated by the board. The board reviews decisions, performance and outcomes of the audit committee. For the most part, the duty to review the audit committee's work exposes all directors to potential liability for negligence.<sup>65</sup>

A director of a company is liable for failing to comply with, or failing to take all reasonable steps to secure compliance with, the financial reporting and audit requirements.<sup>66</sup> This contravention carries a civil penalty. In addition, if the contravention was dishonest, the director commits a criminal offence that carries a penalty of up 15 years of imprisonment.<sup>67</sup>

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<sup>63</sup> Robert P Austin, and Ian M Ramsay, 2018, *Ford, Austin and Ramsay's Principles of Corporations Law*, 17<sup>th</sup> Edition, LexisNexis Butterworths Australia 2018;  
Phillip Lipton, Abe Herzberg and Michelle Walsh, 2018, *Understanding Company Law*, 19<sup>th</sup> Edition, 2018 Corporate Education Services

<sup>64</sup> ASX Listing Rule 12.7

<sup>65</sup> There could be circumstances where directors who are members of the audit committee bear a correspondingly higher duty. Conversely, there might be circumstances where directors who are not members of the audit committee escape liability, because audit committee exist, but would otherwise be liable (*ASIC vs Rich* (2003) 44 ACSR 341)

<sup>66</sup> under Part 2M.2 or 2M.3 or sections 324DAA, 324DAB or 324 DAC;s 344 (1) and (1A)

<sup>67</sup> s 344(2)

## 4.6 Auditor's liability

Auditors incur liability when they contravene the Corporations Act, and when they fail in their duties to their clients. Contraventions of the Act attract statutory liability, while liability associated with duties to clients is derived from common law. Common law is open to interpretation, and some of these interpretations are included in this section. These interpretations are provided to assist the Committee, and come with the caveat that Treasury is not a source of legal advice or authoritative interpreter of common law. Accordingly, the Committee should note that courts make take a different interpretation to those expressed or cited in this section. Sections 4.6.1 and 4.6.3 of this submission refer to contraventions and requirements of the Corporations Act, section 4.6.2 and 4.6.4 are based on common law interpretations.

### 4.6.1 Auditor offences

Contraventions of statutory obligations imposed upon auditors by the Corporations Act are offences. A comprehensive list of all related offences and the applicable penalties is at Attachment A.

Auditors are subject to many of the general provisions in the Corporations Act, many of which attract significant custodial penalties. Penalties for specific audit-related offences vary from 20 penalty units for less significant offences to 5 years imprisonment for the most significant.<sup>68</sup>

The most significant offence, attracting 5 years imprisonment, relates to an auditor making false or misleading statements, or omitting a matter in a manner that will lead to the document being misleading (if that document is one that is required by the Corporations Act, such as an auditor's report).<sup>69</sup>

A lower penalty of two years imprisonment may be imposed where an auditor fails to take all reasonable steps to ensure that a statement is not false or misleading or omits a matter in a manner that will lead to the document being misleading (if that document is one that is required by the Corporations Act, such as an auditor's report).<sup>70</sup>

An auditor commits a less significant offence (one year of imprisonment) if he or she contravenes the obligation to report to ASIC.<sup>71</sup>

The auditor independence provisions in Part 2M4 Division 3 and the auditor rotation provisions in Division 5 carry offences for individual auditors, members of audit firms and audit companies and their directors. Breaches of statutory obligations to comply with auditing standards, to retain audit working papers for seven years, provide the auditor's independence declaration and report to members of the company, disclosing entity, or a trustee for debenture holders are other examples of offences.<sup>72</sup>

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<sup>68</sup> Penalty units are used to define the amount payable for fines for many offences. One penalty unit is currently \$165.22, from 1 July 2019 to 30 June 2020.

<sup>69</sup> s 1308(2)

<sup>70</sup> s 1308(4)

<sup>71</sup> s 311 (1)(2)(3)

<sup>72</sup> ss307A(1)(2), 307B(1)(3), 307C(1)(3),308(1)(3)(3AA)(3AB)(3A)(3C)(4), 309(1)(3)(4)(5)(5A)(6), 313(1)(2)

#### 4.6.2 Auditor's liability to a company

Auditors are not liable for every failure to detect fraud or error. They may be liable under their contract to pay damages to the company for negligence and/or breach of contract if they do not exercise reasonable care and skill when performing an audit which causes a loss.

Before damages are awarded it must be shown that the breach of duty caused a loss. When an auditor does not conduct the audit in accordance with auditing standards and a breach of an auditing standard results in loss or damage, a court may find that the auditor failed to exercise the necessary degree of care and skill.<sup>73</sup>

Prior to the CLERP 9 reforms, auditors were subject to joint and several liability together with other parties such as managers and company directors for economic loss caused by negligence or misleading and deceptive conduct. CLERP 9 introduced two reforms designed to limit the liability of auditors – incorporation of auditors and proportionate liability.

The incorporation of audit firms was meant to allow auditors to take advantage of limited liability afforded by the corporate structure and protect auditors who are not responsible for loss caused by another auditor in the audit firm.

Proportionate liability was introduced for claims for damages for economic loss or property damage arising from negligence or misleading and deceptive conduct.<sup>74</sup> The proportionate liability makes the auditor liable only for that portion of the damage for which he or she is judged to be responsible. For example, if the loss suffered by a company may have been caused by the negligence of its auditor as well as the company's directors and managers, the auditor will be liable only for a proportion of loss attributable to their actions.<sup>75</sup>

#### 4.6.3 Indemnification of an auditor from liability

The Corporations Act imposes limits on the arrangements by which companies might exempt or indemnify their officers or auditors or pay their legal costs or insurance premiums. In particular, a company, or a related body corporate, must not exempt an auditor of the company from liability to the company incurred as an auditor.<sup>76</sup> However, the court may grant the company relief to indemnify auditors against any cost incurred by them in successfully defending any civil or criminal action.<sup>77</sup>

#### 4.6.4 Auditor's liability to third parties

In addition to being liable to a company, an auditor who is found liable for negligence and/or breach of contract may also be liable to shareholders, creditors and other users of the audited accounts if they can establish that the auditor owes them a duty of care in carrying out the audit and in making the report.

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<sup>73</sup> Robert P Austin, and Ian M Ramsay, 2018, *Ford, Austin and Ramsay's Principles of Corporations Law*, 17<sup>th</sup> Edition, LexisNexis Butterworths Australia 2018;

<sup>74</sup> CLERP made amendments to the proportionate liability regime under s12GF(1) of the ASIC Act, s 1041 of the Corporations Act and s 18 of the Australian Consumer Law

<sup>75</sup> *Selig v Wealthsure Pty Ltd* (2015) 320 ALR 47; 105 ACSR 552; (2015) HCA 18.

<sup>76</sup> ss 199A (1) (2) (3)

<sup>77</sup> s 1318

### Prospectus liability

If the auditor's report has been obtained for inclusion in a prospectus and an auditor consented to be named in the prospectus, he or she may be liable to pay compensation to people who subscribe for securities and who suffer loss at the result of a false or misleading statements or omissions made by the auditor in its report.<sup>78</sup>

### Liability to shareholders and potential shareholders

Auditors are not directly liable to shareholders and potential shareholders as they would not ordinarily know that their report is required for a specific shareholders' decision as to whether to buy or sell shares or refrain from buying or selling. An auditor might be liable to potential shareholders if they know that they are intending to act and refrain from acting based on the auditor's report.<sup>79</sup>

### Liability to financiers

Similarly, unless the auditors made a representation with the intention of inducing the financier to act or refrain from acting based on their report, they are not directly liable. It is not sufficient that the auditors know that the report will be communicated to financiers.<sup>80</sup>

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<sup>78</sup> s 729 and s 1041I

<sup>79</sup> *Columbia Coffee & Tea Pty Ltd v Churchill t/as Nelson Parkhill* (1992) 29 NSWLR 141

<sup>80</sup> *R Lowe Lippmann Figdor and Franck v AGC(Advances) Ltd* [1992] 2 VR 671(1992) 8 ACSR 380

## ATTACHMENT A – AUDITOR RELATED OFFENCES

Provision	Description	Penalty
s. 250RA (1) and (3)	Failure of auditor to attend listed company's AGM – individual (1) and lead auditor (3)	20 penalty units
s. 307A(1) and (2)	Failure to conduct audit in accordance with auditing standards – individual (1) and member of firm (2)	50 penalty units (strict liability) or 240 penalty units or 2 years imprisonment, or both (ordinary)
s. 307B(1) and s.307B(3)	Failure to retain audit working papers for 7 years or other specified time – individual (1) or member of firm (3)	50 penalty units
s. 307C(1)	Requirement to give directors, registered scheme or disclosing entity the Auditor's independence declaration – individual	20 penalty units
s. 307C(3)	Requirement to give directors, registered scheme or disclosing entity Auditor's independence declaration – lead auditor	20 penalty units
s. 308(1), (2), (3), (3AA), (3AB), (3A), (3C) and (4)	Auditor's report on annual financial report – requirements	50 penalty units
s. 309(1), (2), (3), (4), (5), (5A) and (6)	Auditor's report on half-yearly financial report – requirements	50 penalty units
s. 311(1), (2) or (3)	Failure to report interference with audit to ASIC – individual (1), member of firm (2) and lead auditor (3)	1 year imprisonment
s. 313(1)(2)	Failure of auditor to provide reports to borrower or trustee for debenture holders	30 penalty units
s. 324CA(1)	Engaging in audit activity despite unresolved conflict of interest – individual	60 penalty units or 6 months imprisonment, or both
s. 324CA(1A)	Failure to notify ASIC of conflict of interest – individual	30 penalty units
s. 324CA(2)	Engaging in audit activity despite conflict of interest due to failure to implement quality control system - individual	30 penalty units
s. 324CB(1)	Engaging in audit activity despite unresolved conflict of interest – member of firm	60 penalty units or 6 months imprisonment, or both
s. 324CB(1A)	Failure to notify ASIC of conflict of interest – member of firm	30 penalty units
s. 324CB(2)	Engaging in audit activity despite unresolved conflict of interest of which another member of the firm is aware	30 penalty units

Provision	Description	Penalty
s. 324CB(4)	Engaging in audit activity despite conflict of interest due to failure to implement quality control system – member of firm	30 penalty units
s. 324CC(1)	Engaging in audit activity despite unresolved conflict of interest – director of firm	60 penalty units or 6 months imprisonment, or both
s. 324CC(1A)	Failure to notify ASIC of conflict of interest – director of firm	30 penalty units
s. 324CC(2)	Engaging in audit activity despite unresolved conflict of interest of which another director of the firm is aware	30 penalty units
s. 324CC(4)	Engaging in audit activity despite conflict of interest due to failure to implement quality control system – director of firm	30 penalty units
s. 324CE(1)	Engaging in audit activity despite being in a 'relevant relationship' – individual	60 penalty units or 6 months imprisonment, or both
s. 324CE(1A)	Failure to notify ASIC of relevant relationship – individual	30 penalty units
s. 324CE(2)	Strict liability offence of engaging in audit activity despite being in a 'relevant relationship' – individual	30 penalty units
s. 324CF(1)	Engaging in audit activity despite being in a 'relevant relationship' – member of audit firm	60 penalty units or 6 months imprisonment, or both
s. 324CF(1A)	Failure to notify ASIC of relevant relationship – member of audit firm	30 penalty units
s. 324CF(2)	Strict liability offence of engaging in audit activity despite being in a 'relevant relationship' – member of audit firm	30 penalty units
s. 324CG(1)	Engaging in audit activity despite being in a 'relevant relationship' – audit company	60 penalty units or 6 months imprisonment, or both
s. 324CG(1A)	Failure to notify ASIC of relevant relationship – audit company	30 penalty units
s. 324CG(2)	Strict liability offence of engaging in audit activity despite being in a 'relevant relationship' – audit company	30 penalty units
s. 324CG(5)	Engaging in audit activity despite company being in a 'relevant relationship' – directors of company	60 penalty units or 6 months imprisonment, or both
s. 324CG(5A)	Failure to notify ASIC of relevant relationship – directors of company	30 penalty units
s. 324CG(6)	Strict liability offence of engaging in audit activity despite being in a 'relevant relationship' – directors of company	30 penalty units
s. 324CI and s. 324CJ	Becoming an officer of audited body within 2 years of ceasing to be a member, director or professional employee of audit company	60 penalty units or 6 months imprisonment, or both

Provision	Description	Penalty
s. 324CK	Multiple former audit firm partners or company directors becoming officers of audited body within 5 years	60 penalty units or 6 months imprisonment, or both
s. 324CM(1), (2) and (3)	Deliberately disqualifying auditor – individual (1), member of audit firm (2) or audit company (3)	60 penalty units or 6 months imprisonment, or both
s. 324DB	Failure to meet auditor rotation obligation – individual	60 penalty units or 6 months imprisonment, or both
s. 324DC(1)	Failure to meet auditor rotation obligation – member of audit firm	60 penalty units or 6 months imprisonment, or both
s. 324DC(2)	Strict liability offence of failure to meet auditor rotation obligation – member of audit firm	30 penalty units
s. 324DD(1) and (2)	Failure to meet auditor rotation obligation – audit company (1) and director of company (2)	60 penalty units or 6 months imprisonment, or both
s. 324DD (3)	Strict liability offence of failure to meet auditor rotation obligation – director of company	30 penalty units
s. 332A(2) or (3)	Failure of auditor to publish annual transparency report (2) or lodge report with ASIC (3)	20 penalty units
s. 1308(2)	General provision – providing to false or misleading documentation	5 years imprisonment
s. 1308(4)	General provision – failure to take reasonable steps to ensure documentation provided is not false or misleading	2 years imprisonment