



**INTERNATIONAL FEDERATION  
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**Agenda Item  
7**

**Committee:** Ethics Committee  
**Meeting Location:** AICPA, New York, USA  
**Meeting Date:** February 14-15, 2005

**Definition of Network Firm**

**Objectives of Agenda Item**

1. To discuss and approve for exposure revisions to the definition of Network Firm

**Background**

The IAASB QC Exposure Draft (ED) included the definition of network firm that is contained in the Code of Ethics. Some respondents to the ED criticized the definition. In light of these criticisms, and the importance of maintaining common definitions within IFAC standards (the IAASB Group Audits ED also uses the definition), a Task Force (TF) was formed to consider whether revisions to the definition were necessary. The TF was comprised of representatives of the Ethics Committee and the IAASB. The membership was

John Kellas (Chair) – IAASB  
Frank Attwood – Ethics  
Heather Briers – Ethics  
Josef Ferlings – IAASB  
Jean Rothbarth - Ethics  
Roger Simnett – IAASB

The Task Force developed the following proposed definition and background material for consideration by the Ethics Committee. This definition and background material would be used for the Code. To maintain consistency of use of definitions in IFAC pronouncements, the IAASB would use this definition, as appropriate, in the group audits and QC standards. For example, the IAASB may decide to adopt a subset of the definition such as “networks firms that have...”.

This material was presented at the Ethic Committee meeting in Vienna and was discussed briefly. However, shortly before the meeting, some members of the Forum of Firms from mid-tier firms indicated they had significant concerns with the proposed change. The Committee felt that it was important to understand the concerns before discussing the proposal in detail.

In June 2004, Marilyn Pendergast, Jean Rothbarth and Jan Munro met with representatives of the Forum of Firms to explain the proposal and answer any questions. At the meeting it appeared that some of the concerns stemmed from a misunderstanding of the scope of the application of independence requirements to network firms. The firms were asked to provide their specific concerns by the end of July so that the issue could be considered at the September Ethics Committee meeting. However, the firms were not able to respond within the timeframe and needed additional time. Therefore, the matter was taken off the September agenda.

In October there was additional communication with the firms and eight firms provided comments on the proposal. Four firms agreed with the wording as suggested, four respondents agreed with the approach but expressed some concern with the wording. These concerns are discussed later in this agenda paper, after the discussion of the development of the proposal.

## Discussion

### EXISTING DEFINITIONS

The existing definitions of firm and network firm are as follows:

Firm     (a) A sole practitioner, partnership or corporation of professional accountants;  
          (b) An entity that controls such parties; and  
          (c) An entity controlled by such parties.

Network firm   An entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.

Respondents to the Quality Control ED noted the following issues with the definition of network firm:

- Member firms of “networks” are separate legal entities and are not under common control, ownership or management. Including reference to control in the network firm definition could result in an inappropriate conclusion that entities in a network are “controlled” by the network organization.
- The definition disregards the importance of how firms present themselves. If an audit firm gives the impression that it is a member of part of an international audit network or organization, it in effect implies that its product, the audit report, provides the level of reliability the network stands for.
- It is inappropriate to have a definition that refers to a reasonable and informed third party *having knowledge of all relevant information*. By definition, most reasonable and informed third parties will not have knowledge of all relevant information. When the appearance is of a single firm that is sufficient to establish a network relationship regardless of whether knowledge of all relevant information might change that perception.

The full text of the comments is provided in the Appendix 1.

In discussing the proposed revisions to the definition of network firm, the TF considered the characteristics that would be relevant to whether a firm should be considered to be a network firm

for independence purposes. The TF also considered how other jurisdictions had addressed the issue, for example, the SEC, the EU, TAC and AICPA. These definitions are contained in Appendix 2 for reference purposes.

In revising the definition, it was necessary to continue to capture those entities that are under common control (the existing definition of firm includes entities that either control the firm or are controlled by the firm). Therefore, the TF proposes that the definition of network firm be replaced by a two-part definition:

- Part (a) will capture firms that use a common brand name or share significant professional resources; and
- Part (b) will capture entities that are under common control.

The TF concluded that it would be useful for the definition to be supplemented by background material containing additional guidance on the thought process that would be used when determining whether a firm is part of a network. The proposed additional text is presented as 290.5a-g below (obviously on exposure the paragraphs would be renumbered to be consecutive).

*Proposed New Definition of Network Firm*

Network firm            (a) a firm that is part of the larger structure to which the firm belongs and which makes use of a common brand name or through which significant professional resources are shared; or

                                 (b) an entity which is connected to the firm by means of common control, ownership or management.

*Proposed Background Material to Definition of Network Firm*

290.5 This section provides a conceptual framework for identifying, evaluating and responding to threats to independence. The framework requires members of assurance teams, firms and network firms to identify threats to independence, evaluate the significance of those threats, and, if the threats are other than clearly insignificant, identify and apply safeguards to eliminate the threats or reduce them to an acceptable level. Judgment is needed to determine which safeguards are to be applied. Some safeguards may eliminate the threat while others may reduce the threat to an acceptable level. This section requires members of assurance teams, firms and network firms to apply the framework to the particular circumstances under consideration. In addition to identifying relationships between the firm, network firms, members of the assurance team and the assurance client, consideration should be given to whether relationships between individuals outside of the assurance team and the assurance client create threats to independence.

290.5a Firms frequently form associations with other firms. Such associations range from those created only to facilitate referral of work (e.g. correspondent firms) to those where the firms operate under a common brand name and have common audit methodology and quality control procedures.

290.5b Whether the degree of association is sufficiently close to create a network is something to be judged in the circumstances. This judgment is made in light of whether a reasonable and informed third party would be likely to conclude that the firms are closely associated in such a way that they are part of a larger structure that uses a

common brand name or through which significant professional resources are shared and are therefore network firms.

- 290.5c Where firms practice under the same name, or substantially the same name, they are to be considered part of a larger structure and therefore to belong to a network. Likewise, where firms include within their names some common element (such as common initials or a common name), they are presumed to belong to a network unless the facts indicate otherwise. As an example of a case where the presumption may be rebutted, if a firm sells a component of its practice, the sales agreement may provide that, for a limited period of time, the component may continue the use the name, or an element of the name, of the firm though they would otherwise be unconnected. In such circumstances while the two firms may be practicing under a common name, the facts are such that they are not part of a larger structure and are, therefore, not network firms.
- 290.5d The way in which a firm presents itself will be relevant. For example, if, in stationery or promotional material, a firm makes reference to being a member of an association of firms, a reasonable and informed third party is likely to conclude, absent any specified limitation or conditions of membership, that the firms in such an association are part of a larger structure and are network firms. Accordingly, unless such a reference explicitly includes information that rebuts such close association the firms would be considered to be network firms.
- 290.5e In determining whether the firms share significant professional resources, consideration is given to the nature of the relationship thereby established. Firms may share such professional resources as:
- Audit methodology, audit manuals or working papers;
  - Training courses and facilities;
  - Technical departments;
  - Data bases for matters such as time recording, billing, client information;
  - Quality control policies and procedures; and
  - Partners and staff.
- 290.5f When concluding whether the professional resources shared are significant and therefore indicate that the firms are part of a larger structure, a reasonable and informed third party would consider the relationship established by the professional resources shared. Where the shared resources are limited to common methods, with no exchange of personnel or client or market information, it is unlikely that the shared resources would be considered to be significant. There is little difference in practice between a group of firms combining to form a group to develop methodologies, and the case where a number of firms independently purchase proprietary audit methodology material from a commercial developer and supplier. The same may well apply to common training endeavor. Where, however, the shared resources involve an exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created to provide specific advice to participating firms, a third party is more likely to conclude that the shared resources are significant and that the firms are part of a network. This will be all the more likely if the relevant firms also use their association for promotional purposes.

- 290.5g Even though firms within a network may be legally separate and distinct entities, if they make use of a common brand name or share significant professional resources a reasonable and informed third party would conclude that the firms are part of a larger structure and are, therefore, network firms.
- 290.6 The examples presented in this section are intended to illustrate the application of the framework and are not intended to be, nor should they be interpreted as, an exhaustive list of all circumstances that may create threats to independence. Consequently, it is not sufficient for a member of an assurance team, a firm or a network firm merely to comply with the examples presented, rather they should apply the framework to the particular circumstances they face.

### **Feedback from Forum of Firm Members**

Eight firms responded on the proposal. Four were supportive of the material as presented. Two firms stated that there should be more focus on how the member firms present themselves. The external focus would be evaluated on a combination of how the member firms present themselves to the marketplace by using a common name (or common elements of a name) and a common audit approach. It was felt that the common audit approach would be based on whether the member firms agree to a mandatory adoption and implementation of a common quality assurance system including audit methodology and independence policies. One firm was concerned that the proposed definition would inadvertently include (a) associations of firms that are created primarily to facilitate referred work, but who also share a common element of their name or refer to their membership of the association in their stationery and marketing materials, or (b) correspondent firms in an association.

When developing the approach, the TF was of the view that if firms practice under the same name or substantially the same name they would be considered to be part of a larger structure and therefore belong to a network. The TF felt that a common audit methodology was not in itself sufficient to indicate that significant resources were shared.

Two firms commented on the paragraph 290.5d:

The way in which a firm presents itself will be relevant. For example, if, in stationery or promotional material, a firm makes reference to being a member of an association of firms, a reasonable and informed third party is likely to conclude, absent any specified limitation or conditions of membership, that the firms in such an association are part of a larger structure and are network firms. Accordingly, unless such a reference explicitly includes information that rebuts such close association the firms would be considered to be network firms.

The firms stated that an example of such a rebuttal should be provided. Should Committee members agree that an example should be provided the italicized language could be added:

Accordingly, unless such a reference explicitly includes information that rebuts such close association, *by for example, stating that the association is for referral purposes only*, the firms would be considered to be network firms.

One firm commented that it was not clear how much a firm would need to do to ensure network firm compliance with independence requirements. For example, the independence requirements prohibit network firms from providing certain non-audit services to audit clients. Does a firm have to survey every network firm member to obtain confirmation that no such services have been provided? ISQC1 (IAASB International Standard for Quality Control) states that:

The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the IFAC Code and national ethical requirements....

Such policies and procedures should require:

... engagement partners to provide the firm with relevant information about client engagements, including the scope of services to enable the firm to evaluate the overall impact, if any, on independence requirements;

... the accumulation and communication of relevant information to appropriate personnel so that the firm and its personnel can readily determine whether they satisfy independence requirements.”

While the ISQC does provide some guidance it does not specifically address the issue of how much is enough to provide the firm with reasonable assurance. The matter has been communicated to the IAASB.

#### **Action Requested**

1. Ethics Committee members are asked to consider the proposed definition and background material and the comments received from the firms.
2. Ethics Committee members are asked to approve the material for exposure

## Appendix 1

#	Respondent	Comment
<b>Definition – Network Firm</b>		
1.	Basel Committee on Banking Supervision	The standard defines “Network firm” as “an entity under common control, ownership or management with the firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as being part of the firm nationally or internationally.” Normally, the audit report adds credibility to financial information issued for consumption in capital markets. If an audit firm gives the impression that it is a member or part of an international audit network or organisation, it in effect implies that its product, the audit work and report, provides the level of reliability that the network stands for. Thus, the definition of network firm as drafted is not sufficient because it disregards the importance of how firms present themselves.
2.	IOSCO	In the context of ISQC 1, we question whether it is appropriate to qualify the definition of a “network firm” by referring to “a reasonable and informed third party <u>having knowledge of all relevant information</u> ” (emphasis added). By definition, most reasonable and informed third parties will not have knowledge of all relevant information dealing with the nature of the relationships that exist among, for example, national firms that operate as part of an international network. In our view, when the appearance is of a single firm that is sufficient to establish a network relationship regardless of whether knowledge of all relevant information might change that perception.
3.	KPMG	We acknowledge that the definition of “Network Firm” is the same as that which is included in the IFAC Code. However, we are quite concerned that by combining a legal situation of an entity being under common control together with a situation involving the perceptions of others regarding whether an entity should be considered part of a firm could result in an inappropriate conclusion that entities in a network firm are considered to be “controlled” by the network organization. We therefore suggest that the definition of “Firm” be expanded to include entities that are in fact, by virtue of the legal structure, controlled and therefore correctly included in the legal parameters of the firm. The definition of “Network Firm” should then be confined to addressing the other situation of entities that are not under direct or common control but which are included in the network organization. In this regard, we believe it important to unambiguously avoid any reference to control. We are not aware that such a situation (involving control) exists with any of the international organizations. In our experience each member firm is a separate legal entity from each other member firm and none of the firms are “under the common control, ownership and management” of the respective international entity. Accordingly, the definition of Network Firm should address “entities which, while not under common control....etc., belong to a common organization that seeks to establish consistent professional standards among its members”.

## Appendix 2

### Other definitions of network or network firm

#### *TAC*

The definition in the Code of Ethics differs from the definition used by TAC. Per the constitution:

“Network firms means those firms which practice nationally or internationally under the same name, or whose member firms are otherwise closely associated with one another as through common elements in their name or through reference to membership of the network in their promotional material and on their stationery; such networks shall be regarded for the purpose of membership of the Forum as single organizations.”

#### *EU Independence*

The Statutory Auditor’s Independence in the EU: – A set of Fundamental Principles contains the following definition of network:

“Includes the audit firm which performs the Statutory Audit, together with its Affiliates and any other entity controlled by the Audit Firm or under common control, ownership or management or otherwise affiliated or associated with the Audit Firm through the use of a common name or through the sharing of significant common professional resources.”

#### *EU 8<sup>th</sup> Directive*

The definition in the draft EU 8<sup>th</sup> directive also refers to a common name:

"Network shall mean the larger structure to which a statutory auditor or an audit firm belongs and which makes use of a common brand-name or through which professional resources are shared."

#### *SEC*

The SEC definition, as such, is incorporated into the definition of accounting firm:

“Accounting firm means an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability partnership, or other legal entity) that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization’s departments, divisions, parents, subsidiaries, and *associated entities*, including those located outside of the United States. Accounting firm also includes the organization’s pension, retirement, investment or similar plans.”

The definition of accounting firm was revised in 2000. The exposure of the document contained the term “affiliate of the accounting group” rather than “associated entity”. The term affiliate was separately defined to include a broad range of entities that are either financially tied to or otherwise associated with the accounting firm. The proposed definition received a great deal of comment on exposure. Many respondents felt that the definition was too broad. In response to these concerns, the final SEC rule used the term “associated entities”. While the term is not defined, the SEC stated in the release of the rule that it intends this phrase to “reflect our staff’s current practice of addressing these questions in light of all relevant facts and circumstances,



looking to the factors identified in our staff's previous guidance." Much of this guidance is in the form of staff letters in response to specific fact patterns.

*AICPA*

The AICPA's definition of a "covered member" includes:

- a. An individual on the attest engagement team;
- b. An individual in a position to influence the attest engagement team;
- c. A partner or manager who provides [more than 10 hours of] nonattest services to the attest client...
- d. A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
- e. The firm, including the firm's employee benefit plans; and
- f. An entity whose operating, financial or accounting policies can be controlled (as defined by GAAP for consolidation purposes) by any of the individuals or entities described in a through e or by two or more such individuals.