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Agenda Item

3

Committee Ethics Committee

Meeting Location: Radisson SAS, Rome, Italy

Meeting Date: June 13-14, 2005

Definition of Network Firm

Objectives of Agenda Item

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

Background

At the February 2005 meeting, the Ethics Committee discussed a proposed revised definition of network firm and background material that had been developed by a joint Task Force of the Ethics Committee and the IAASB. The proposal had been discussed at the annual meeting of the forum of firms and the firms had indicated the approach was workable.

The Committee noted that it was important to consider the proposed definition of a network firm contained in the 8th directive. It was agreed that the Ethics Committee Task Force¹ should continue to monitor any such changes.

It was noted that the second part of the definition “an entity which is connected to the firm by means of common control, ownership or management” should be restructured. The Committee discussed what level of ownership would be necessary to conclude that a firm was part of a network. The Committee concluded that while it was probably not possible to draw a bright line, it would be useful if the Task Force developed some guidance in this area.

The Committee noted that while a network firm may not be in a position to influence the outcome of an audit there was an effect on independence in appearance. The Committee felt that the holding out as being part of a network contributed to the appearance issue and should be given greater emphasis in the background material. The Committee noted however, that some jurisdictions have encouraged small firms and sole practitioners to form associations to for example, share some technical resources and therefore improve quality. It was important that associations would not automatically be captured under the definition and background material for those reasons.

¹ Frank Attwood (chair), Heather Briers, Ken Dakdduk, Jean Rothbarth and Lisa Snyder

It was agreed that the Task Force should bring back a revised definition and background material for approval at the June 2005 meeting.

8th Directive

At the time of writing this agenda paper the following definition and background material was being considered for inclusion in the 8th directive:

“Network” means the larger structure:

- Which is aimed at cooperation to which a statutory auditor or an audit firm belongs, and;
- Which is clearly aimed at profit or cost sharing or share common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand-name, or a significant part of professional services.

"... In order to determine the independence of auditors, the concept of “network” in which auditors operate needs to be clear. In this regard, various circumstances have to be taken into account such as instances where a structure could be defined as a network because it is aimed at profit or cost sharing, which may also be demonstrated if statutory auditors and/or audit firms have common usual clients. The criteria for establishing that there is a network should be judged and weighed on the basis of all factual circumstances available. ."

It is difficult to make any accurate prediction as to when the 8th directive will be approved but it would seem that a vote in Committee in June is possible, after which it would then need to go to plenary. An update on any changes in the timing of approval will be provided at the Rome Ethics Committee meeting.

Discussion

Representatives of the Task Force met with the US Association of CPA firms to obtain information on how these associations were structured. The following matters were discussed – responses received are presented in italics:

- How they would describe their associations on letterhead, in publications and in proposals
The responses varied by association – the majority of the firms describe themselves on their letterhead with words such as “independent firm of ABC Association” and include the association logo. The majority of firms do not use the name of the association in the firm name at the top of the letterhead.
- Whether any of the following professional resources were shared by members of the association:
 - Audit methodology, audit manuals or working papers
 - Training courses and facilities
 - Technical departments
 - Databases for matters such as time recording, billing and client information
 - Quality control policies and procedures

- Partners and staff

Common methodology is not required, most firms use practice aids developed by either the profession or a third party. Most associations sponsor staff and other training but this is for economies of scale and not for the purposes of achieving commonality.

Some firms do establish the use of subject matter experts as consultant. However, if a member firm uses such a subject matter expert there is a separate arrangement between the member firm and the consultant's firms – i.e. it is not the association providing the technical expertise.

Firms within the associations do not use common data bases and client information is seen as confidential to the firm and would not be shared with other firms within the association.

Partners and staff are very seldom shared but may occasionally provide for exchange of staff overseas.

- Whether a firm within the association would compete with another firm within the association

There is competition between firms. Associations may have territorial restrictions which prevent a firm from opening an office in a particular area but the firm would still compete for client's within that area. The firms do not have a common business strategy.

- Whether, in a group audit situation, a firm would review the work of another firm within the association

A firm would not rely on the work of another firm within the association without first satisfying themselves as to the appropriateness of the audit work performed. Firms would also (as appropriate) refer to the work of the other firm in the audit report – which is not different than if the firm used another firm that was outside of the association. If an association firm is referred audit work of a subsidiary of a client, the referring firm's audit partner may visit the other firms and might supervise the engagement.

- Whether they share client lists across firms within the association

Client lists are never shared and are considered strictly confidential. Firms within an association may provide information for benchmarking purposes but would never disclose a client name.

- Whether a firm within the association would take an audit engagement for an entity where a partner in another firm in the association was a director of the entity.

This could happen.

The Task Force considered the information obtained from the association of firms and the view expressed from the Ethics Committee in February in redrafting the proposed definition and background material.

Material Presented

Agenda Paper 3	This Agenda Paper
Agenda Paper 3-A	Proposed Revisions to Network Firm Definition and Background Material (clean copy)
Agenda Paper 3-B	Proposed Revisions to Network Firm Definition and Background Material (mark-up copy)

While a clean and mark-up copy have been provided for the convenience of Committee members, the discussion at the June meeting will focus on the mark-up copy.

Action Requested

1. Ethics Committee members are asked to approve for exposure the proposed definition and background material.