

NETWORK FIRMS

The International Federation of Accountants (IFAC) has issued a revised definition of what constitutes a network in its Code of Ethics. The revised principles-based definition, which is consistent with the Statutory Audit (revised 8th Company Law) Directive, focuses on how groups of firms operate and present themselves. The independence requirements that apply to networks have not changed.

Network firms are required to be independent of an audit client of another firm within the network. The revised definition of networks issued by IFAC its Code of Ethics does not change the independence requirements that apply to networks.

The revised principles-based definition, which is consistent with the Statutory Audit (revised 8th Company Law) Directive, focuses on how groups of firms operate and present themselves.

According to the revised guidance, a firm will be deemed to be part of a network if it part of a larger structure aimed at co-operation and profit or cost sharing, or shares 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 resources.

What are the consequence of being a network?

You have to be independent of audit clients of other network firms, which implies the need for a pro-active system to identify independence issues throughout the network.

IFAC Code of Ethics: 290.14 “Financial statement audit engagements are relevant to a wide range of potential users; consequently, in addition to independence of mind, independence in appearance is of particular significance. Accordingly, for financial statement audit clients, the members of the assurance team, the firm and network firms are required to be independent of the financial statement audit client....”

Note that the independence requirement has not been changed in this respect, either by the revised 8th Directive or the change to the IFAC discussion on networks; these concentrate on what firms are or are not part of a network.

In doing this, you need to take account of a variety of independence requirements around the world, which sometimes means having to

apply the most stringent requirements across the board (clearly an aspect in which harmonisation is good¹).

The APB elected to apply their own standards rather than use IFAC²: complying with their standards results in all material respects in complying with IFAC, but the other way around does not apply. Apart from that, the APB is one of the more reasonable standards in terms of extraterritoriality, requiring APB Standards to apply re UK & Irish network firms, but IFAC to be applied to other network firms involved in the audit.

APB Ethical Standards Glossary: “audit firm” *[which in the Standards has to be independent]* “...For the purpose of APB Ethical Standards, audit firm includes network firms in the UK and Ireland, which are controlled by the audit firm or its partners.”

APB ES1,46 and 47 “The group audit engagement partner should be satisfied that other auditors (whether a network firm or another audit firm) involved in the audit of the group financial statements, who are not subject to APB Ethical Standards, are objective and document the rationale for that conclusion.” “The group audit engagement partner obtains written confirmation from the other auditors that they have a sufficient understanding of and have complied with the IFAC Code of Ethics for Professional Accountants, including the independence requirements.”

Some other countries cheerfully take sweeping extraterritorial powers, though pushing the responsibility down to the local firm in the network as they do not have legal extraterritorial powers. The codes are typically structured along lines that if any overseas group auditor (in some cases any overseas material group auditor) does not comply with the particular requirements, then the group auditor in the home country will not be considered to be independent. Examples are the US, Belgium and more recently France, though interestingly the Belgian parliament approved removal of the extraterritorial requirements in late Summer 2006 (possibly as a result of the new 8th Directive provision which seeks to stop this sort of thing³:

Revised 8thD Article 34(2): “In the case of a statutory audit of consolidated accounts, the Member State requiring the statutory audit of the consolidated accounts may not impose additional requirements in relation to the statutory audit concerning registration, quality assurance review, auditing standards, professional ethics and independence on a statutory auditor or audit firm carrying out a

¹ We have consistently pushed for ethics harmonisation towards IFAC, with the APB and within Europe. We can also claim a large part of the credit for getting IFAC to adopt the principles based approach.

² See 1

³ Again, we (and FEE) pushed for the 8th Directive to be a vehicle for ensuring that national regulators did not go too far away from IFAC. Article 34(2) was a strong nod towards this desire, though of course it technically allows the ‘home auditor shall not be independent’ stance.

statutory audit of a subsidiary established in another Member State.”)

The EC legal services arm is looking at the French position and is expected to pronounce later in January 2007.

What is a network?

The revised 8th Directive has adopted a new definition which in essence considers a network to be a structure that acts in common, or appears to act in common, or has common ownership or control.

Revised 8th Directive definitions: “network: means the larger structure:
– which is aimed at cooperation and to which a statutory auditor or an audit firm belongs, and
– which is clearly aimed at profit- or cost-sharing or shares common ownership, control or management, common quality-control policies and procedures, a common business strategy, the use of a common brand-name or a significant part of professional resources.”

IFAC is adopting an essentially identical definition, which member bodies should seek to apply for audit reports signed after 31 December 2008. The final IFAC definition includes some discussion paragraphs which interpret what the definition means (expected to be issued imminently). They seek to apply a principles based approach and thus require groups themselves to consider whether they are networks. In essence, if a grouping either holds itself out as acting in concert (common name, etc) or acts so closely together that any of them could influence the audits carried out by any other, then they should consider themselves a network. This inevitably pleases some commentators and not others and the guidance raises questions itself.

The substance of the existing APB definition of a network firm (derived from the EU Recommendation on Auditor Independence) is not dissimilar to the new one:

“Any entity:
(i) controlled by the audit firm or
(ii) under common control, ownership or management or
(iii) otherwise affiliated or associated with the audit firm through common name or through the sharing of significant common professional resources.”

The existing IFAC definition of a network firm is:

“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.”

This arguably gets to the point rather more succinctly but as the new definition is from the 8th Directive, Europeans would have had to pick up something new anyway.

The big firms and a lot of the mid tier firms already regard themselves as networks and this won't change. A lot of smaller, loose referral groupings of independent firms do not regard themselves as networks and this should not change. However, given that there is a more detailed set of criteria, it is feasible that some smaller mid-tier groupings might find themselves within the definition of networks when they were not previously.

If in doubt, consider the threats and apply common sense.

The threats are: (i) undue influence on the audit through intra network control or other means of exerting influence – in which case the network firms should be independent of the audit client; or (ii) networks acting in such a way that the reasonable and informed third party (an EC phrase picked up by IFAC) would consider them to be one firm and therefore it would look very odd and uncondusive to public confidence if the network firms were not independent of each others' clients.

Overall

There is clearly a cost to the network structures mentioned above. Networks are set up to allow out of region or international audit business to be done more easily. Audits need confidence and independence is a cost of maintaining that confidence. We have sought to keep the network requirements as harmonised and as principles based as possible. This is an interminable battle though and networks/groupings can play your part in responding to consultations. This does mean matters are not always black and white and it will require interpretations to be made by groupings. That is the price of allowing common sense to flourish, and a regime that tries to be approximately right rather than precisely wrong in a wide variety of circumstances.

The revised definition will be incorporated into [Section 290: Independence – Assurance Engagements](#) in the Institute's Code of Ethics in due course.

Section 290 applies to:

- assurance engagements other than audit engagements in the UK and Ireland;
- audit engagements in territories other than the UK and Ireland;

As far as audits in the UK and Ireland are concerned, the Auditing Practices Board is likely to consider revising their definition of networks as part of their overall review of their Ethical Standards next year.

If you have any feedback on IFAC's revised network definition, please send your comments to tony.bromell@icaew.co.uk or anne.davis@icaew.co.uk by March 2007.