

July 2005  
Invitation to Comment

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Response Due Date  
3 September 2005

*IFAC ED of Proposed Revision to the IFAC Code of Ethics*

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## **Definition of Network Firm**



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

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Hong Kong Institute of CPAs Invitation to Comment

IFAC Exposure Draft

IFAC Press Release

This Invitation to Comment may be filed in the “Exposure Drafts, Invitations to Comment” section of Volume I of the Institute Members’ Handbook.

A copy of the Invitation to Comment can also be found on the Institute’s website at:  
[www.hkicpa.org.hk/professionaltechnical/ethics/exposedraft/IFAC\\_ED\\_networkfirm.pdf](http://www.hkicpa.org.hk/professionaltechnical/ethics/exposedraft/IFAC_ED_networkfirm.pdf).



## INVITATION TO COMMENT

The International Federation of Accountants (IFAC) is seeking comments on the attached Exposure Draft (ED) which has been posted on the Institute's website at: [www.hkicpa.org.hk/professionaltechnical/ethics/exposedraft/IFAC\\_ED\\_networkfirm.pdf](http://www.hkicpa.org.hk/professionaltechnical/ethics/exposedraft/IFAC_ED_networkfirm.pdf). It can also be found on-line at [www.ifac.org/Ethics/](http://www.ifac.org/Ethics/).

In accordance with the Institute's International Standards Convergence Due Process, the Institute's Ethics Committee invites comments on the IFAC ED from any interested party and would like to hear from both those who do agree and those who do not agree with the proposals contained in the IFAC ED. Comments should be supported by specific reasoning and should preferably be submitted in written form.

The IFAC ED seeks comments on a new definition of network firm and provides background material on the interpretation of this new definition. As a background to commentators, the Institute adopted in November 2003 the "Independence for assurance engagements" section of the IFAC Code of Ethics as Professional Ethics Statement 1.203A "Independence for assurance engagements" and Professional Ethics Guidance 1.308 of the same title. Paragraph 3(q) of Professional Ethics Statement 1.203A contains a definition of "network firm" which is the same as that contains in the IFAC Code of Ethics issued in November 2001.

To allow your comments on the IFAC ED to be considered and included in the Institute's submission to the IFAC Ethics Committee, they are requested to be received by the Institute on or before **3 September 2005**. Comments may be sent by mail, fax or e-mail to:

**Stephen Chan**  
**Executive Director**  
**Hong Kong Institute of Certified Public Accountants**  
**4th Floor, Tower Two, Lippo Centre**  
**89 Queensway**  
**Hong Kong**

**Fax number: (852) 2865 6776**  
**E-mail: [commentletters@hkicpa.org.hk](mailto:commentletters@hkicpa.org.hk)**

Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

*July 2005*

*Proposed Revised Section 290*

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## Independence–Assurance Engagements



International Federation  
of Accountants

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## **REQUEST FOR COMMENTS**

This exposure draft of the Ethics Committee of the International Federation of Accountants (IFAC) was approved for publication in June 2005. The proposed revised Section 290 “Independence–Assurance Engagements” may be modified in light of comments received before being issued in final form.

Comments should be submitted so as to be received by September 30, 2005 preferably by e-mail or on computer disk, or in writing. All comments will be considered a matter for the public record. Comments should be addressed to:

Jan Munro  
IFAC Ethics Committee  
545 Fifth Avenue, 14 Floor  
New York, New York 10017 USA

Email responses should be sent to: [Edcomments@ifac.org](mailto:Edcomments@ifac.org)

The approved text of this exposure draft is published in the English language. In order to achieve maximum exposure and feedback, the International Federation of Accountants encourages the reproduction of this publication in any format.

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## **EXPLANATORY MEMORANDUM**

### **Introduction**

This memorandum provides background to, and an explanation of, the proposed revised Section 290 “Independence – Assurance Engagements” approved for exposure by the Ethics Committee of the International Federation of Accountants in June 2005.

### **Background**

Section 290 (previously Section 8) establishes independence requirements for professional accountants in public practice who perform assurance engagements. Under the section, network firms are required to be independent of an audit client of a firm within the network. For other types of assurance engagements, consideration should be given to any threats that the firm has reason to believe may be created by network firm interests and relationships. Some had expressed concern with the definition of network firm contained in the section believing that it was too narrow and did not appropriately consider the importance of the way firms present themselves. In light of this concern, the Ethics Committee initiated a project to review the definition of network firm.

### **Significant Proposals**

The proposed revised Section 290 contains a new definition of a network firm and provides background material on the interpretation of this definition.

The proposed revised Section 290 recognizes that firms frequently form associations with other firms. Such associations range from those created only to facilitate referral of work to those where the firms operate under a common brand name and have common audit methodology and system of quality control, both of which are mandatory.

The proposed revised Section 290 states that whether the degree of association is sufficient to create a network that would require firms in the network to be independent of each other’s financial statement audit clients is something to be judged in the circumstances. A firm would be considered to be a network firm if it is part of a larger structure and (i) uses a name in its firm name that is common to the larger structure; or (ii) shares significant professional resources with other firms in the larger structure; or (iii) shares profits or costs with other firms within the larger structure. A firm would also be considered to be part of a network if it controls the firm, is controlled by the firm or is under common control with the firm through ownership, management or other means.

### **Effective Date**

The Ethics Committee recommends that the proposed revised Section 290 is effective for assurance reports dated on or after December 31, 2006.

### **Guide for Commentators**

The Ethics Committee welcomes comments on the proposed revised Section 290 with respect to the changes related to the definition of a network firm. Comments are most helpful when they

## EXPLANATORY MEMORANDUM

refer to specific paragraphs, include the reasons for the comments, and, where appropriate, make explicit suggestions for any proposed changes to wording.

Recognizing that the proposed revised Section 290 will apply to assurance engagements of all sizes and in all sectors of the economy, the Ethics Committee is also interested in comments on matters set out below:

### **Developing Nations**

Recognizing that many developing nations have adopted, or are in the process of adopting, the Code of Ethics for Professional Accountants, the Ethics Committee invites respondents from these nations to comment, in particular, on any foreseeable difficulties in applying the proposed revised Section 290 in a developing nation environment. Reasons should be provided, as well as alternative or additional guidance.

### **Translations**

Recognizing that many respondents intend to translate the proposed revised Section 290 for adoption in their own environments, the Ethics Committee welcomes comment on potential translation issues noted in reviewing this exposure draft.

## Section 290

### Independence–Assurance Engagements

- 290.1 In the case of an assurance engagement it is in the public interest and, therefore, required by this Code of Ethics, that members of **assurance teams**,\* firms and, when applicable, **network firm**\*s be independent of assurance clients.
- 290.2 Assurance engagements are designed to enhance intended users’ degree of confidence about the outcome of the evaluation or measurement of a subject matter against criteria. The International Framework for Assurance Engagements (the Assurance Framework) issued by the International Auditing and Assurance Standards Board describes the elements and objectives of an assurance engagement, and identifies engagements to which International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs) and International Standards on Assurance Engagements (ISAEs) apply. For a description of the elements and objectives of an assurance engagement reference should be made to the Assurance Framework.
- 290.3 As further explained in the Assurance Framework, in an assurance engagement the professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
- 290.4 The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter. The term “subject matter information” is used to mean the outcome of the evaluation or measurement of subject matter. For example:
- The recognition, measurement, presentation and disclosure represented in the **financial statements**\* (subject matter information) result from applying a financial reporting framework for recognition, measurement, presentation and disclosure, such as International Financial Reporting Standards, (criteria) to an entity’s financial position, financial performance and cash flows (subject matter).
  - An assertion about the effectiveness of internal control (subject matter information) results from applying a framework for evaluating the effectiveness of internal control, such as COSO or CoCo, (criteria) to internal control, a process (subject matter).
- 290.5 Assurance engagements may be assertion-based or direct reporting. In either case they involve three separate parties: a public accountant in public practice, a responsible party and intended users.
- 290.6 In an assertion-based assurance engagement, which includes a **financial statement audit engagement**,\* the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

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\* See Definitions.

- 290.7 In a direct reporting assurance engagement the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users. The subject matter information is provided to the intended users in the assurance report.
- 290.8 Independence requires:
- Independence of Mind*
- The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.
- Independence in Appearance*
- The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised.
- 290.9 The use of the word "independence" on its own may create misunderstandings. Standing alone, the word may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.
- 290.10 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires firms and members of assurance teams to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest.

### **A Conceptual Approach to Independence**

- 290.11 Members of assurance teams, firms and network firms are required to apply the conceptual framework contained in Section 100 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.

## ASSURANCE ENGAGEMENTS

- 290.12 The examples presented in this section are intended to illustrate the application of the conceptual 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.
- 290.13 The nature of the threats to independence and the applicable safeguards necessary to eliminate the threats or reduce them to an acceptable level differ depending on the characteristics of the individual assurance engagement: whether it is a financial statement audit engagement or another type of assurance engagement; and in the latter case, the purpose, subject matter information and intended users of the report. A firm should, therefore, evaluate the relevant circumstances, the nature of the assurance engagement and the threats to independence in deciding whether it is appropriate to accept or continue an engagement, as well as the nature of the safeguards required and whether a particular individual should be a member of the assurance team.

### **Network Firms**

- 290.14 Firms frequently form associations with other firms. Such associations range from those created only to facilitate referral of work (where the firms would commonly be referred to as correspondent firms) to those where the firms operate under a common brand name and have common audit methodology and system of quality control, both of which are mandatory.
- 290.15 Whether the degree of association is sufficient to create a network that would require firms in the network to be independent of each other's financial statement audit clients 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, weighing all the factual circumstances available, irrespective of whether the firms are legally separate and distinct entities, they are closely associated in such a way that they are part of a network.
- 290.16 Where a firm practices under the same firm name (or substantially the same firm name) as other firms in the larger structure to which it belongs or includes within its name a significant element that is common to other firms in the larger structure (such as common initials or a common name), it would be considered to belong to a network unless the facts indicate otherwise. As an example of a case where the facts indicate otherwise, 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 network. In such circumstances the firms should disclose that they are not connected when presenting themselves to outside parties.

## ASSURANCE ENGAGEMENTS

290.17 In some circumstances, a firm that does not meet the criteria of a network firm may describe itself as being a member of an association of firms (for example in its stationery or promotional material). This description may create the appearance that the firm is part of a larger structure. To avoid such an appearance, such a firm should clearly describe the nature of its membership of the association, for example, by stating on its stationery or promotional material that it is “an independent firm associated with XYZ Association of Accounting Firms”.

290.18 In determining whether the firms share significant professional resources, consideration is given to the nature of the relationship thereby established. Firms may share professional resources for example:

- Common systems that share information such as client data, billing and time recording;
- Partners and staff;
- Quality control policies and procedures;
- Technical departments;
- Audit methodology, audit manuals or working papers; and
- Training courses and facilities.

290.19 When concluding whether the professional resources shared are significant and therefore indicate that the firms are part of a network, this consideration is judged and weighed on the basis of all the factual circumstances available. 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 develop methodologies, and a number of firms independently purchasing proprietary audit methodology from a commercial developer and supplier. The same may well apply to common training endeavor. Where, however, the shared resources involve the regular exchange of people or information, such as where staff are drawn from a shared pool, or a common technical department is created within the larger structure to provide specific advice to participating firms that the firms are required to follow, 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.

*[Paragraphs 290.14 - 290.34 of extant Section 290 would remain unchanged but would be renumbered paragraphs 290. 20 – 290.40]*

## DEFINITIONS

In this Code of Ethics for Professional Accountants the following expressions have the following meanings assigned to them:

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.~~

(a) a firm that is part of a larger structure and that:

(i) uses a name in its firm name that is common to the larger structure; or

(ii) shares significant professional resources with other firms in the larger structure; or

(iii) shares profits or costs with other firms within the larger structure;

or

(b) an entity that controls, is controlled by, or is under common control with the firm through ownership, management or other means.



**International Federation of Accountants**

545 Fifth Avenue, 14<sup>th</sup> Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1(212) 286-9570 [www.ifac.org](http://www.ifac.org)

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**For Further Information**

Helene Kennedy +1-973-394-9256

(Mobile) +1-917-254-6706

helenekennedy@ifac.org

Bryan Hall + 1-212-471-8719

bryanhall@ifac.org

## **IFAC Strengthens its Code of Ethics and Invites Comments on Revised Definition of Network Firm**

*(New York/June 29, 2005)* -- Demonstrating professional integrity and independence in today's environment is one of the most significant challenges faced by professional accountants. A newly revised [Code of Ethics for Professional Accountants](#), recently released by the Ethics Committee of the International Federation of Accountants (IFAC), provides updated guidance in this area.

The revised Code establishes a conceptual framework for all professional accountants to ensure compliance with the five fundamental principles of professional ethics. These principles are integrity, objectivity, professional competence and due care, confidentiality, and professional behavior. Under the framework, all professional accountants will be required to identify threats to these fundamental principles and, if there are threats, apply safeguards to ensure that the principles are not compromised. The framework applies to all professional accountants, those in public practice and those in business, industry and government.

"The revised Code protects the public interest by requiring all professional accountants to be alert to situations that could potentially compromise their compliance with the Code's fundamental principles and to take action to ensure that the principles are not compromised," explains Ethics Committee Chair Richard George.

The revised Code also conforms to the International Framework for Assurance Engagements, issued by the International Auditing

and Assurance Standards Board, and definitions contained in the International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance Related Services Engagements*. To assist with the implementation of these conforming changes, the Ethics Committee has also issued an interpretation providing guidance on the application of the independence requirements to assurance engagements that are not financial statement audit engagements.

"The Ethics Committee is to be congratulated on issuing the revised Code," states IFAC President Graham Ward. "The revised Code is further demonstration of the international profession's commitment to act in the best interest of the public."

The revised Code is effective June 30, 2006. Earlier adoption is encouraged. It can be viewed and downloaded by going to [www.ifac.org/Store/](http://www.ifac.org/Store/).

### **Definition of a Network Firm**

The Ethics Committee has also issued an exposure draft (ED) that proposes revisions to the definition of a network firm. Network firms are required to be independent of an audit client of a firm within the network. The proposed changes would classify a firm as a network firm of another firm if the two share a common brand name or if they share significant professional resources or revenues, profits, costs or expenses.

"The revised definition focuses not only on how the firms operate, but also on how they present themselves," explains Ethics Committee Chair Richard George. "When firms present themselves as part of a large structure, as is the case with many of the global firms, the public expects the independence requirements to apply to the complete network."

The new ED, [Proposed Revised Section 290, Independence - Assurance Engagements](#), may be downloaded from the IFAC website by going to [www.ifac.org/EDs](http://www.ifac.org/EDs). Comments are requested

by September 30, 2005. They may be submitted to [edcomments@ifac.org](mailto:edcomments@ifac.org) or faxed (+1-212-286-9570) or mailed to the attention of Jan Munro at IFAC, 545 Fifth Avenue, 14th Floor, New York, NY 10017 USA. All comments will be considered a matter of public record and will ultimately be posted on IFAC's website.

IFAC is the worldwide organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC's current membership consists of 163 professional accountancy bodies in 119 countries, representing more than 2.5 million accountants in public practice, education, government service, industry and commerce. The organization sets international standards of ethics, auditing and assurance, education and public sector accounting and issues guidance to encourage high quality performance by professional accountants in business.