

Informal comments on practical implementation of “network definition” in the EU Statutory Audit Directive – and relation to IFAC definition

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Introduction

This note has been drafted on the basis of an on-going and informal dialogue between the ICAEW and a number of international accountancy and auditing groupings. The note is intended as a discussion document and considers issues raised informally by these groupings¹. It does not represent the views of the ICAEW.

The observations focus on potential practical implementation questions which arise from the inclusion in the EU Statutory Audit Directive (2006/43/EC) of a definition of “network” (Article 2, paragraph 7). They also take into account the revised definition of network by the International Federation of Accountants (IFAC) in Section 290 “Independence Assurance Engagements”, as approved by the International Ethics Standards Board for Accountants (IESBA) on 14 July 2006. The revised IFAC definition is very closely aligned with the Statutory Audit Directive definition.

The development of the EU and IFAC definitions reflects the long-term market response on the part of the accountancy and audit profession to the growing international nature of business and the increased demand for concomitant professional services. This response has resulted in many different forms of trans-national relations between accounting and auditing practices across the European Union and in other countries. Collectively, these arrangements have attracted the label of “networks” although this label has often been used in a generic sense rather than to imply a specified form of relationship. It is recognised that, due to the inclusion within the Statutory Audit Directive of a definition of network, and the work of IFAC, this situation will now change. However, it is also noted that there are many uncertainties within the professional accountancy community as to the nature of the change and it is from this context that the present note has been drafted.

Summary of issues raised

This note draws attention to the need for very careful consideration at EU and indeed global level of the interpretation and practical implementation of the network definition in the Statutory Audit Directive. This is also the overriding thrust of the explanatory paragraphs to the IFAC definition. Such careful consideration is essential

¹ One of channels through which these views have been gathered is the regular ICAEW International Networks Meeting.

to avoid unintended costs and burdens on the accountancy profession, and in turn on businesses both in the EU and globally, which would be disproportionate to the public interest objective of the Directive.

The issues raised in this paper fall into two broad areas:

➤ Clarity and consistency of scope of application

In a principles-based Directive, it is right that the definition should seek to arrive at the substance of whether a grouping/association is a network rather than to set detailed, arbitrary rules. However, it is of critical importance that EU Member States do not take widely differing views or inadvertently broaden the scope of application well beyond those international accounting structures that would commonly be regarded as networks. They could seek to include others such as small accountancy practices which have loose links with one another across jurisdictions for the purposes solely of making professional referrals. It does not appear that it was the intention, as the EU Directive was being adopted, to include within the scope of the definition such practices, which rarely (if at all) will be undertaking statutory audits of public interest entities, as defined in the minimum harmonisation level contained in the Directive. However, without clarification and guidance, this could occur.

➤ Practical implications of falling under the definition: regulatory requirements

This note also deals with the anticipated practical consequences arising from the interaction between the network definition and other key provisions in the Directive. These principally relate to independence and transparency and raise questions regarding proportionality and cost/benefit analysis of regulation in relation to the public interest. The potential for unanticipated consequences arising from the definition in the context of the broader evolution of liability and case law is also addressed.

In the following sections, the specific issues arising under these two broad areas are examined in detail.

Detailed issues

The following key issues have been identified as areas of concern.

1) Unclear scope of application

It is currently unclear how the EU definition will be interpreted and implemented in terms of scope at EU Member State level. The question remains as to how many of the current international accounting associations and structures outside of the four largest international audit structures will meet the EU definition. It should be noted that the four largest firms do not contest (nor indeed does the ICAEW) that they meet the definition - although they may/do have questions regarding the practical consequences arising from meeting the new definition.

In particular, initial thoughts are that there is a lack of clarity in the following areas:

- it is unclear what the Directive means where it refers, in Article 2, paragraph 7, to “belongs.” [“network means the larger structure: - which is aimed at cooperation and to which a statutory auditor or an audit firm belongs”]. Clarification is required as to what type of relationship should be considered to mean “belonging”.

For example, can a state of “belonging” be said to arise out of the payment alone of a “membership fee” by a statutory auditor/audit firm to a larger structure where this larger structure undertakes no commercial activity and assists only in activities such as information exchange, referral of clients, annual meetings etc. between otherwise independent accountancy/auditing practices? Similarly, can this state of “belonging” be interpreted to exist where a statutory auditor/audit is listed in a “directory of firms” which again functions as a mechanism for client referrals?

It should be noted that different categories of membership are a common feature of many of the structures in place today. It is unclear whether account will be taken of this in the implementation process. For example, in many of the international groupings/networks in existence today, there can be two-tiers of membership: full member firm and correspondent firm. A final point in this regard is what status is to be given to non-accounting and non-auditing practices within a grouping/network given that a number of such groupings/networks are multi-disciplinary.

A further common feature is that an individual accountancy/audit practice may “belong” to more than one international accounting/auditing association and may be listed in more than one directory. In these cases, if the implementation of the Directive’s provisions on independence and transparency were to apply in all of the existing international groupings/networks, this could become complex and burdensome (see point 3 below).

- The network definition is composed of a list of alternative criteria, only one of which needs to be met in order for a structure to be deemed a network. It is unclear whether some sort of de minimis level of override can be applied on a cost-benefit basis.

- The alternative criteria in the list are themselves broadly defined. It is right that the definition should seek to arrive at the substance of an arrangement rather than the form, but this creates questions of interpretation. For example, sharing “common quality-control policies and procedures” is extremely wide-ranging: not least because many firms from different international associations/networks today apply ISQC1, as promulgated by the International Auditing and Assurance Standards Board (IAASB). Many international accounting associations organise annual or more regular conferences at which quality assurance is discussed: in these cases, should such meetings be deemed sufficient for the structures to be considered as networks?
- Similarly, it is unclear what is meant by “common brand name”, and whether this would also encompass the use of a common “pre-fix” and the use of a common logo/name in conjunction with a local/national name. We note that the IFAC definition refers to “common initials or a common name”, which denotes a network in IFAC’s view.
- Recital 11 of the Directive, relating to the network definition, potentially opens up still further the prospect of a very broad application of the definition, especially through the reference to the existence of “common usual clients.” The need for clarification is particularly important given that this term has not been included in the definition and a structure may indeed have such common clients even though they are serviced independently by different accountancy practices.
- It is unclear whether Member States, or the EU collectively, would seek to use a specific reference point or thresholds to assist in the delineation of networks. For example, will the EU wish to use the criteria of membership of the IFAC Forum of Firms to identify networks or quantitative thresholds, such as the combined fee income of the international groupings?

2) Consistency of interpretation and even application of regulation

Consistency of interpretation of the network definition across EU jurisdictions is critical to the successful implementation of the Directive and to achieving even and consistent application of regulation. We note, however, that there is no anticipated mechanism at EU level for interpreting the network definition as this measure is not subject to comitology and the issue does not appear to have been included on the agenda of the European Group of Auditors’ Oversight Bodies (EGAOB).

From the perspective of cohesiveness of EU policy in the audit sphere, it would be unsatisfactory for EU Member States to take a different view on the same international accounting/auditing association as to whether or not it meets the network definition. This matter requires some attention.

As is also recognised in the IFAC Definition and explanatory paragraphs, there is the possibility that an accounting/auditing firm may inadvertently give the appearance of being part of a network, even though the structure in question is not such a network. This could occur on account of the accounting/auditing firm’s

involvement as part of an international association, mechanism for referring clients or other liaisons with other accounting/auditing practices. As noted above, it would be beneficial to avoid this mis-categorisation.

Conversely, an accounting/auditing firm may inadvertently or otherwise give the appearance of not being part of a network, even though in fact it is part of a network and derives benefit from being so, but because of its appearance it avoids the regulatory requirements which impact on other networks. This is to be avoided as it would represent a distortion of competition and an uneven application of regulation.

Most importantly, differing interpretations between Member States in respect of the network definition or the uneven application with regard to the existing international groupings/associations would be extremely disruptive to the EU Internal Market. The practical implications would be wide-ranging, for example in relation to the implementation of independence provisions with potential negative repercussions in the competition sphere. (see point 3 below).

For the above reasons, it is suggested that the explanatory paragraphs to the IFAC definition are used as a benchmark for EU Member States, or at least as a basis for any discussions within the EGAOB and among EU Member States.

3) Interaction with other key provisions in the Directive: independence and transparency

The importance of achieving clarity of application of the definition becomes manifest when one considers the interaction between the network definition and other key provisions in the Directive. This interaction raises significant questions regarding investment in trans-national infrastructure for the accounting entities and in turn additional costs for business. It is foreseen (and, it is believed, was foreseen by the European Commission in drafting the proposal for the Directive) that the following articles will have direct interaction with the network definition and associated practical consequences:

- i) Independence (Article 22 – bearing in mind that some EU Member States appear to be using Article 52 to introduce more stringent independence requirements over and above the minimum harmonisation in Article 22).

- ii) Transparency (Article 40) (also in relation to the definition of public interest entity: Article 2, paragraph 13)

i) Independence

The main concerns regarding the practical implementation of the network definition arise from the independence requirements introduced by the Directive. The Directive will require that the auditors' independence procedures encompass potential conflicts and other matters arising from the network (or, rather, specifically network firms) to which the auditor "belongs".

It is already common procedure for accounting and auditing practices in an association/network operating within a single jurisdiction to address matters arising

from the national association/network. In addition, IFAC has long had a requirement for network firms to comply with independence requirements on a network-wide basis. The major accounting firms - the four largest firms and a small number of other internationally firms - already have some infrastructure in place.

However, it is unclear whether this existing infrastructure will be sufficient to meet all of the Directive's requirements and, if not, what additional compliance requirements and associated costs will be imposed on the firms. This is due to the fact that the practical implementation of independence rules is itself still to be clarified on account of the minimum harmonisation nature of the independence provisions in the Directive (see below). Furthermore, the new EU definition and the associated independence requirements could result in some of the current international accounting and auditing structures being considered to be networks for the first time, with associated new costs.

A number of specific questions/issues arise out of these broad considerations:

- Will a cost-benefit analysis in relation to public interest be undertaken in relation to the trans-national scope of application of independence requirements across networks? In the absence of this or a similar analysis, it is possible that the legislation will result in the need for costly infrastructure to ensure compliance among many of the existing smaller international accounting and auditing structures. This could be disproportionate to the public interest and would generate costs which would ultimately be passed on to business.
- Clarity on the costs of compliance is a key matter for accounting and auditing firms within associations/networks. It is important that firms are given a clear signal with regard to the nature of regulatory requirements arising from the network definition so that they may make an informed decision about whether to remain within a network or whether to make other arrangements. There is currently uncertainty among individual firms about the possible repercussions of remaining within a grouping which might, or might not, be considered to be a network.
- The exact nature of the trans-national application of independence requirements – both within and outside the EU – needs to be carefully assessed. There are currently uncertainties in this respect. These arise out of the known divergence of views among national authorities in EU Member States in relation to policy on auditor independence and the apparent intention, permitted by Article 52, to introduce additional independence requirements over and above those required under Article 22.

In these cases, there is considerable potential for extra cost in the provision of audit services both within the EU and globally in cases where there is no clear public interest rationale. We believe that this danger exists as it is currently unclear how such additional requirements, if introduced by one or more Member States, would impinge on the network firms outside of the EU jurisdictions in which they are introduced.

With regard to the impact within the EU, we note the principle of mutual recognition of regulatory arrangements between Member States, enshrined in Article 34. However, while this article deals specifically with the statutory audit of consolidated accounts and subsidiaries thereof and cases regarding listed entities on EU markets, it does not provide clarification in the case of other relationships. Therefore, questions remain as to whether independence requirements beyond the EU minimum would be conveyed across an entire accounting network outside of the contexts of a group audit and of audits of listed entities if such requirements are introduced in one EU Member State, notwithstanding Article 34 (2).

It should be reiterated that, whatever the interpretation and implementation of Article 34, the practical implementation of trans-national provisions – i.e. the minimum EU requirements set out in Article 22 – would become complex and disruptive to the markets if Member States adopt differing interpretations of the criteria which must be fulfilled in order for the network definition to be met.

- It is unclear whether the process to render independence requirements trans-national across networks will relate to *all* accounting and auditing firms which “belong” to a network or whether a distinction will be made according to different categories of membership. Similarly, clarification is required with regard to the treatment of networks which “share” a member firm in certain EU jurisdictions and in third countries (often due to the limited number of suitable accounting and auditing firms in certain countries)
- It is unclear whether the process to render independence requirements trans-national across networks will relate to all firms, including those in other disciplines which are members of a network. In many cases, the existing international groupings/networks are multi-disciplinary and include not only accounting and auditing firms but also other practices, notably (but not only) in the legal services sphere.
- Questions surrounding the practicability and enforcement of the independence provisions appear, in the final instance, to be very pertinent. With regard to practicability, the issue is not only the investment in infrastructure which the international networks would have to put in place (which, as above, may be burdensome and disproportionate). In order to maintain such infrastructure, the audit firms within the networks may be dependent on their clients to provide the relevant information about their sourcing of other services. There will be limits to the extent that an audit firm can place obligations on clients to obtain this information.

In relation to enforcement or policing, there remain questions as to the mechanisms which will be required in this respect and the costs which would be involved. Again, there is the risk that these costs would be disproportionate and would ultimately be passed on to audit clients.

ii) Transparency

A number of important practical implementation issues arise in the area of transparency, as required by Article 40. Among the most important are:

- The scope of application of the transparency requirements is uncertain and could, without guidance on implementation, become disproportionately burdensome. The Directive includes among its special provisions for the statutory audits of public-interest entities, that “where the audit firm belongs to a network, a description [is required] of the network and the legal and structural arrangements in the network”.

It would appear that such a description would be required in the case of an international accounting network even if just one of its member firms is auditing one public interest entity in one EU Member State. It is to be recalled that there is no harmonised definition of public interest entity: as per Article 2, paragraph 13, Member States may designate an entity to be of public interest outside of the minimum requirements in the Directive. This increases the likelihood that the entity will be audited by a member firm of one of the smaller and more informal international accounting/auditing associations.

- The transparency report requirements in Article 40 are extensive and in some cases generic (see below), which raises questions regarding practical impact. Furthermore, they are only minimum requirements. It is unclear whether there will be guidance or efforts to coordinate implementation between Member States to ensure that transparency reports provide all the necessary information to meet public interest requirements but do not go beyond this, and in so doing impose disproportionate burdens.
- A number of specific requirements in Article 40 may merit coordination at EU level with regard to application. In particular, paragraph 1 b) requiring “a description of the network and the legal and structural arrangements in the network”. There are a number of common issues faced by accountancy and auditing practices when servicing international clients which are likely to emerge in any such “description”. For example, as noted in point 1 above, existing networks and associations of accounting/auditing firms have different categories of membership. These are used for a variety of reasons, including issues which are often outside of the control of the audit firms themselves (for example, shortage of appropriately qualified individuals and firms, other professional constraints from the wider business environment). Similar questions may also arise in relation to “affiliates of an audit firm,” given the definition in Article 2 (paragraph 8) [“any undertaking, regardless of its legal form, which is connected to an audit firm by means of common ownership, control or management”].

The requirement to describe “legal and structural arrangements” necessitates particular attention for potential consequences in the sphere of professional liability which may not have been unforeseen by the EU legislator in adopting the Directive. (see point 6 below)

5) Uncertainty regarding the relationship between the EU definition and other international/global practice

The inclusion of the network definition in the Directive clearly has repercussions beyond the European Union. Consequently, in the interests of avoiding disruption to the provision of audit services or a negative impact on competition for the audit services across the world, it is important that there is a common policy approach between the EU and, at least, major third country jurisdictions. Overlapping network definitions, differing interpretations of scope of application of the definitions and of the associated international independence and transparency requirements must be avoided.

It is suggested that the IFAC definition and the related explanatory paragraphs, should be used as a basis to achieve coherent policy on a global basis, or at least to begin a discussion on how to achieve such a policy.

6) Potential for unintended consequences: trans-national professional liability and litigation

There are currently significant concerns within the professional accountancy and auditing community regarding the potential trans-national impact of the application of the network definition in terms of professional liability arrangements and litigation. These concerns are of a magnitude that a number of international accounting and auditing associations are giving serious consideration to their existing structures, with a view to ensuring that they will not fall under the network definition under the Directive, even if this might restrict their ability to service trans-national clients.

The Statutory Audit Directive includes an important provision on professional liability (Article 31) and a report is expected from the European Commission before end 2006. The inclusion of Article 31 stems from a broadening recognition of the difficulties which arise from having diverse liability arrangements in Europe for the audit profession. Similarly, there is a growing recognition of the problem at the global level.

Within the European Union, many EU Member States currently have no liability limitation in place for auditors, although there is a growing awareness of the potential negative consequences for the auditors and the capital markets more generally in these specific jurisdictions. Notably, a number of Member States have had limitations for some time and others (such as Belgium and the UK) have recently moved or are moving in this direction. However, what is still unclear are the consequences for international accounting/auditing networks of leaving liability unlimited in the remaining EU Member States. Also the consequences for accounting and auditing firms within the EU of leaving liability unaddressed in third countries are demanding further attention.

These questions are highly relevant to how the EU Member States implement the Statutory Audit Directive's network definition. It is already clear from recent and on-going cases against audit firms that their international associations/structures

have attracted significant attention in litigation claims. Specifically, plaintiffs have demonstrated an increased tendency to focus their litigation on the international structure, pointing to the assertion of control between accounting and auditing practices in different jurisdiction. This tendency is motivated by a desire to find additional sources of compensation.

Given this trend, it is important there is consideration at EU level as to how, in future possible cases, the courts will interpret the concept of control and in turn professional liability across jurisdictions in light of the inclusion of the network definition in EU legislation. The consequences of recognising in law the existence of international networks of accounting and auditing practices with common names, business strategy, common clients etc, needs to be carefully assessed. It is possible that the courts could find that the network definition is applicable not only in relation to the independence and transparency requirements in the Statutory Audit Directive, but also to liability issues through 'holding out' that a series of legally separate firms are operating as one. Recognition of this fact could lead to a more aggressive and internationally focused litigation trend targeted at the accounting and auditing networks which in turn could dissuade accounting and auditing practices to remain in such structures. Again, disruption of audit services and a further degree of concentration in the audit market could result.

In this overall context, attention also needs to be given to the possible consequences of Member States interpreting and transposing the network definition in different ways. Ultimately, however, the key question will remain what the consequences will be for the viability of the networks, and the profession more generally, of the courts ruling in favour of plaintiff attempts to pursue "deeper pockets" across jurisdictions when in many jurisdictions there are (still) no limitations of professional liability for auditors.

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