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FREQUENTLY ASKED QUESTIONS AND SAMPLE CASE STUDIES FOR IMPLEMENTING NETWORK FIRM GUIDANCE

The staff of the Ethics Division developed the following nonauthoritative frequently asked questions and sample case studies to assist members in understanding and implementing Interpretation No. 101-17, "Networks and Network Firms," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .19), and related definitions. Such guidance does not amend or override the AICPA Code of Professional Conduct (AICPA Code), and reading the nonauthoritative guidance is not a substitute for complying with the AICPA Code. Further, the guidance is not meant to be exhaustive; members and others should always refer to the AICPA Code. The guidance does not establish best practices nor does it set standards or serve as official pronouncements of the AICPA. Members should consult their state board of accountancy rules to determine what, if any, impact joining an association of firms may have on their practice.

APPLICATION TO FOREIGN NETWORK FIRMS

In August 2011, the Professional Ethics Executive Committee approved a revision to ET section 91, *Applicability* (AICPA, *Professional Standards*), of the AICPA Code that states that a member who is a member of a network firm would not be subject to discipline if a firm within the network that is located outside the United States (foreign network firm) departed from any of the ethics requirements stated herein, as long as the foreign network firm's conduct, at a minimum, is in accord with the ethics and independence requirements set forth in the International Ethics Standards Board for Accountants' (IESBA's) Code of Ethics for Professional Accountants.

FREQUENTLY ASKED QUESTIONS

General

1. How does the adoption of Interpretation No. 101-17 affect firms?

Firms that cooperate as part of an association and share one or more of the following specified six characteristics will be considered to be part of a network and need to be independent of financial statement audit and review clients of other network firms when issuing unrestricted reports on such financial statements. The six characteristics are as follows:

- Sharing a common brand name
- Sharing common control
- Sharing profits or costs

- Sharing a common business strategy
- Sharing significant professional resources
- Sharing common quality control policies and procedures

For all other attest clients, consideration should be given to any threats that the firm knows or has reason to believe may be created by network firm interests and relationships. If those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level.

2. A CPA firm joins an association and is considered to be a network firm because one or more of the six characteristics of a network exists. Would the consulting company controlled by a CPA firm also be considered a network firm?

Yes. The consulting company would also be considered a network firm because the CPA firm controls the consulting company.

Prohibited Interests and Relationships

3. What interests and relationships are a network firm prohibited from having with the attest clients of other network firms?

Network firms are required to be independent of the financial statement audit and review clients of other network firms. The most common prohibitions are as follows:

- Firms within the network are prohibited from having
  - — direct or material indirect financial interests in such clients.
  - — material close business relationships with such clients.
  - — any loans (except those expressly permitted under Interpretation No. 101-5, "Loans From Financial Institution Clients and Related Terminology," under Rule 101 [AICPA, *Professional Standards*, ET sec. 101 par. .07], of the AICPA Code) to or from such clients.

  These prohibitions do not extend to individuals in the firm, provided that they are not considered to be covered members with respect to the client (for example, partners and managers who provide 10 or more hours of nonattest services to the client or an individual in a position to influence the engagement).
- Firms within the network are prohibited from providing any nonattest services that impair independence to such clients (see Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101 [AICPA, *Professional Standards*, ET sec. 101 par. .05], of the AICPA Code).
- Partners and employees of all network firms are prohibited from serving as an officer, a director, or an employee of such clients.

For all other attest clients, a network firm should consider any threats that the firm knows or has reason to believe may be created by other network firms' interests in, and relationships with, the client and, if those threats are not at an acceptable level, should apply safeguards to eliminate the threats or reduce them to an acceptable level.

4. An immediate family member of a partner in network firm A is a member of the board of directors of an audit client of network firm B. Would network firm B's independence be impaired?

No. Independence would not be impaired, provided that the partner in network firm A is not considered to be a covered member with respect to network firm B's audit client. For example, the partner should not be part of the audit engagement team, should not be in a position to influence the audit engagement, and should not provide 10 or more hours of nonattest services to the audit client.

Common Brand Name (also see Case Study A)

5. Would a firm be considered part of a network if it belongs to an association and includes the association's name as only *part* of its firm name?

Yes. A firm that uses the association's name as all or part of its firm name would be considered part of a network with any other firms in the association that use the association's name as all or part of their firm names. If only a subset of firms in an association use a common brand name, then only that subset of firms would be considered a network, provided that none of the other characteristics of a network are met by the other firms.

6. Would a firm be considered part of a network if it belongs to an association and includes reference to its membership in the association on its stationery and promotional materials?

No. A firm that does not use the association name as all or part of its firm name but, rather, refers to itself, for example, as "an independent member firm of XYZ Association" on its stationery or in its promotional materials would not be considered part of a network, provided that none of the other characteristics of a network are met.

7. A CPA firm joins an international association. The CPA firm itself does not share any of the six characteristics of a network with other firms in the association. However, for purposes of performing multinational audit engagements, the CPA firm has set up a subsidiary that uses the association name as part of the subsidiary name and issues reports under such name. Would the subsidiary or CPA firm, or both, be considered part of a network?

Yes. The subsidiary would meet the common brand name characteristic of a network and, therefore, be considered a network firm. In addition, because the subsidiary is controlled by the CPA firm, the CPA firm would also be considered to be part of the network.

8. Two firms that are members of an association do not use the association's name as part of the firm name but do have similar firm names. One firm is located in Ohio, and its firm name is Smith & Company, PC. The other firm is located in Tennessee, and its firm name is Smith & Company, LLP. Would these firms be considered sharing a common brand name?

No. These two firms would not be considered to be sharing a common brand name because the two firms did not form a larger association under the name "Smith" with the intent of cooperating for the purpose of enhancing those firms' capabilities to provide professional services. The characteristic of sharing a common brand name was not intended to apply to those entities that join an association and happen to have similar names that do not include the association's name.

Common Control

9. If an association has the ability to terminate a firm's membership in the association when a firm fails to comply with any of the association's membership requirements, would the firms in the association be under common control by the association?

No. The association's ability to terminate membership if a firm fails to comply with membership requirements would not constitute having common control over the firms.

Profits and Costs

10. Firms within an association refer and receive work to and from one another. As part of the referral, the firm receiving the work will pay a percentage of the client fees to the referring firm as a referral fee. Would firms in the association be considered sharing profits?

No. The fee paid or received for the referral of work to other firms within the association would not be considered sharing profits. Rule 503, *Commissions and Referral Fees* (AICPA, *Professional Standards*, ET sec. 503), of the AICPA Code, however, requires that any firm that accepts or pays a referral fee for the referral of a client should disclose such acceptance or payment to the client.

Common Business Strategy (also see Case Study B)

11. Under a profit sharing arrangement, 30 percent of the profit of each member firm of an association is pooled and redistributed to individual firms based on a formula that rewards for achievement of a common business strategy. Would members of this association be considered a network?

Yes. The association would not only be sharing a common business strategy but would also be sharing profits.

Significant Professional Resources (also see Case Studies C, D and E)

12. An association provides member firms with access to audit manuals and checklists, training courses, and a technical hotline to consult on technical or industry-specific issues. The firms are not required to use these materials nor are they required to follow the technical advice. Would the shared professional resources be considered significant?

No. Provided that the firms do not share a significant amount of human resources or significant client information (for example, client data, billing, and time records) and have the ability to make independent decisions regarding technical matters, audit methodology, and training, the firms are not considered to be sharing significant professional resources.

Common Quality Control Policies and Procedures (also see Case Study E)

13. An association requires that all its member firms adopt quality control policies and procedures that are compliant with International Standards on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*. Would the firms in the association be considered to be sharing common quality control policies and procedures?

No. The firms would not be considered to be sharing common quality control policies and procedures.

14. An association develops a professional standards manual that outlines, among other things, specific quality control policies and procedures that member firms are required to follow. Member firms are subject to periodic quality control reviews based on the quality of the regional or national peer review process, or both, as well as other factors stated in the manual. Would the firms in the association be considered to be sharing common quality control policies and procedures?

Yes. When an association requires member firms to follow specific quality control policies and procedures and monitors compliance with such policies and procedures, the member firms would be considered to be sharing common quality control policies and procedures.

CASE STUDIES

CASE STUDY A—COMMON BRAND NAME AND SIGNIFICANT PROFESSIONAL RESOURCES

FACTS

A is an international association of firms operating in 60 different countries and established to provide global services to clients. Each firm is a separate and distinct legal entity. Twenty member firms include A’s name as part of their firm name, and another 15 member firms share a technical hotline to consult on technical or industry-specific issues. Member firms that share the technical hotline are required to follow the technical advice provided.

ANALYSIS

A is an international association of firms that cooperate for the purpose of enhancing the firms’ capabilities to provide professional services. The 20 firms that use A’s name as part of the firm name will meet the common brand name characteristic. In addition, because the 15 firms that that share the association’s technical hotline are required to follow the advice provided and do not have the ability to make an independent decision on the matter consulted, those firms are considered to share significant professional resources.

CONCLUSION

The firms that use A’s name as part of their firm name will be considered network firms of other member firms that use A’s name as part of their name. The firms that share the technical hotline will also be considered network firms of other member firms that share the technical hotline.

Member firms that neither use A’s name as part of their firm name nor share the technical hotline will not be considered part of the network.

CASE STUDY B—COMMON BUSINESS STRATEGY

FACTS

B is an international association of firms established to provide global services to clients. Each firm is a separate and distinct legal entity. Member firms all support the association’s broad objective of enabling member firms to meet the needs of their clients through the referral of work to other member firms around the globe. Member firms provide their clients throughout Europe, the Middle East, Latin America, and North America with the highest quality accounting, business, and tax services. Its business strategy is to increase the service capability of firms within the association by adding new member firms with diverse expertise or assisting existing member firms to develop new expertise. However, member firms are not required to assist B in pursuing that strategy.

Member firms implement their own unique business strategies (for example, specific market penetration and industry expansion strategies) and have the ability to compete with other firms within the association and implement a business strategy that is in their firm’s own best interest.

ANALYSIS

B is an international association of firms that cooperate for the purpose of enhancing the firms’ capabilities to provide professional services but do not share a common business strategy. Although member firms support the association’s broad objectives (that is, enabling member firms to meet the needs of clients through the referral of work to member firms around the globe), member firms are not required to implement or assist B in pursuing its business strategy (that is, to increase the service capability of firms within the association by adding new member firms with diverse expertise or assisting existing member firms to develop new expertise). Further, member firms have the ability to implement their own unique business strategies and compete with other firms within the association, which is an indicator that a common business strategy is not being shared.

CONCLUSION

Member firms of B would not be considered network firms.

CASE STUDY C—SIGNIFICANT PROFESSIONAL RESOURCES

FACTS

C is an association of firms operating primarily in the United States. Each member firm is a separate and distinct legal entity. Firm AB is a member of C, with offices in the New York and New Jersey area. An audit client of firm AB is headquartered in New Jersey and has stores throughout the country. To facilitate movement of inventory to its stores, the audit client has distribution centers in New Jersey, Texas, and California. Firm AB arranges for member firms of C located in Texas and California to observe the year-end inventory counts of their audit client. Would these three firms be considered to be sharing significant professional resources?

ANALYSIS

C is an association of firms that cooperate for the purpose of enhancing the firms' capabilities to provide professional services. Although staff and partners are considered professional resources, the firms would not be considered to be sharing significant professional resources in such limited capacity.

CONCLUSION

Firm AB and the two member firms that assist it would not be considered part of a network. However, the professionals that work on the inventory counts should be independent of the audit client.

CASE STUDY D—SIGNIFICANT PROFESSIONAL RESOURCES

FACTS

D is an association of 10 firms operating primarily in the New York Tri-State area. Five of the firms have offices in New York, 3 have offices in New Jersey, and 2 have offices in Connecticut. Although each member firm is a separate and distinct legal entity, the staff from each of the offices are pooled together and assigned to engagements throughout the Tri-State area based on their vicinity to the firms' clients. For scheduling and billing purposes, the firms have access to a shared database containing staff time records and schedules, billing records, and certain client data. Would these 10 firms be considered sharing significant professional resources?

ANALYSIS

D is an association of firms that cooperate for the purpose of enhancing the firms' capabilities to provide professional services. Sharing personnel, scheduling, time records, and billing information would be considered to be sharing significant professional resources.

CONCLUSION

Member firms of D would be considered a network.

CASE STUDY E—COMMON QUALITY CONTROL POLICIES AND PROCEDURES AND SIGNIFICANT PROFESSIONAL RESOURCES

FACTS

E is an international association of firms operating in 60 different countries and established to provide global services to clients. Each firm is a separate and distinct legal entity. When performing financial statement audit engagements, all firms use an audit methodology and audit manuals developed by E that set a minimum level of standards that must be followed, but each firm has the ability to establish more stringent standards. Each firm implements its own system of quality control policies and procedures. All firms agree that their system of quality control will meet certain minimum standards established by E for the referral of work between member firms. E has the ability to periodically review a firm to determine if it is meeting the minimum standards. This review is not intended to nor does it replace the monitoring procedures implemented by the firms.

ANALYSIS

E is an international association of firms that cooperate for the purpose of enhancing the firms' capabilities to provide professional services but do not share common quality control policies and procedures or significant professional resources. Specifically, because the quality control policies and procedures implemented by member firms are not designed by E, the member firms would not be sharing common quality control policies and procedures. In addition, although the use of the audit methodology and audit manuals developed by E would be considered professional resources, because a significant amount of human resources or client or market information is not also shared, they would not be considered significant.

CONCLUSION

Member firms of E would not be considered a network.