



UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Bureau of Competition

APR - 9 2010

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Kelly Hnatt
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Dear Ms. Hnatt:

This letter responds to your request for a staff Advisory Opinion concerning the law enforcement intentions of the Federal Trade Commission's ("FTC" or the "Commission") Bureau of Competition ("BC") with respect to the American Institute of Certified Public Accountants' ("AICPA") proposed expansion of its "independence rule."¹ For the reasons discussed below, FTC staff has no present intention to recommend to the FTC that it challenge adoption of the expanded independence rule as it has been described to staff. This present intention relies entirely on a review of the written materials you have provided to FTC staff, other representations you have made, and an interview with Securities and Exchange Commission ("SEC") officials to whom you directed FTC staff. Should there be information that we are unaware of that qualifies, modifies, or contradicts any of this information or calls in to question the conclusions we have drawn from it, or should the independence rule or its implementation change in the future, we may change our law enforcement recommendation accordingly.

Significantly, we cannot conclude, on the facts before us, that competitive concerns with respect to AICPA's expansion of its independence rule can be wholly ruled out. Application of the expanded independence rule could, at least in principle, produce anticompetitive effects in some geographic markets, and facts necessary to evaluate that possibility are lacking. Nonetheless, we find that the aggregate benefits of the independence rule expansion are likely to be substantial, while the anticompetitive consequences, if any, are speculative and likely to be localized. Thus, our present intention is not to recommend a challenge to the expansion of the independence rule; however, we will be attentive to any customer complaints to the effect that implementation of the expanded rule by a specific AICPA-member network has anticompetitively limited available supply of accounting services or otherwise caused anticompetitive outcomes. If we receive well-founded complaints of that kind, they could result in our recommendation to the Commission to challenge the lawfulness of specific AICPA-member networks or our reconsideration of our decision not to recommend that the Commission challenge the expanded AICPA independence rule.

1. Letter from Kelly M. Hnatt to Donald S. Clark requesting an FTC staff Advisory Opinion (April 2, 2010). ("Hnatt Letter")

Summary of Representations and Written Materials

Based on the representations you have made and the written materials you have provided, we understand the following to be accurate:

- AICPA is a national, professional organization of certified public accountants, with approximately 350,000 members.² Nearly forty percent of AICPA's members perform audit services for clients.³ Membership in AICPA is voluntary.⁴
- AICPA has developed a Code of Professional Conduct ("Code") that governs all AICPA members.⁵ The Code is interpreted and enforced by AICPA's Professional Ethics Executive Committee ("PEEC")⁶. A member's violation of the Code may result in expulsion from the organization.⁷
- The Code addresses various ethics principles relevant to the accounting profession, including: independence, integrity, and objectivity; compliance with applicable standards; responsibilities to clients; and other matters affecting the reputation of the profession.⁸
- Some of AICPA's members have formed "networks."⁹ A network is a collaborative enterprise that, among other things, can assist small network member-firms to achieve some efficiencies of size and scope.¹⁰
- Accounting networks exist in a variety of forms.¹¹ PEEC defines a network as an association of entities that includes one or more firms that cooperate for the purpose of enhancing the firms' capabilities to provide professional services and whose members possess one or more of the following characteristics: common brand name; common

2. Hnatt Letter at 2.

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* at 4.

10. *Id.*

11. *Id.*

control; sharing of profits or costs; common business strategy; the sharing of significant professional resources; and common quality control policies and procedures.¹² The extent of economic integration across accounting networks can vary significantly.¹³

- The business basis for the formation of networks is to enable AICPA members to compete more effectively by enhancing their marketing efforts and allowing them to gain access to new markets; improving the quality and efficiency of services by leveraging the professional skills of other firms; and providing a referral network for clients that need non-attest services that their auditors cannot provide.¹⁴ The formation of networks permits smaller and medium-sized firms to compete for the business of larger companies.¹⁵ This business is currently dominated by the “Big Four” accounting firms.¹⁶
- Under AICPA’s Code, members are obligated to adhere to “independence” standards.¹⁷ Independence has two components: independence of mind (also referred to as independence in fact), and independence in appearance.¹⁸ The purpose of the independence standard is to assure that a CPA performing an audit or other attest service acts with objectivity and professional skepticism when performing that service. Independence is therefore fundamental to the reliability of auditors’ reports and to investors’ confidence in financial statements.¹⁹ Reliable financial statements reduce investor, prospective creditor, and others’ risk with respect to evaluating the financial health of business entities.²⁰
- AICPA members perform many professional services, including audit services.²¹ An audit of a client’s financial statements concludes with an opinion by the auditor on the fairness of the client’s financial statements, in all material respects, with regard to the client’s financial position, results of operations, and cash flows.²² The auditor opines

12. PEEC Interpretation No. 101-17, “Networks and Network Firms.” See Exhibit D.

13. Hnatt Letter at 4.

14. *Id.* at 4.

15. *Id.*

16. *Id.*

17. *Id.* at 2.

18. *Id.* at 3.

19. *Id.*

20. *Id.* at 9.

21. *Id.* at 4.

22. *Id.* at 3.

whether the client's financial statements are presented in conformity with generally accepted accounting principles ("GAAP").²³ Audits are conducted in accordance with generally accepted auditing standards ("GAAS").²⁴

- AICPA members also perform non-audit services.²⁵ Non-audit services may include, among other things, performing management functions; making management decisions; preparing source documents used to generate the client's financial statements; authorizing, executing, or consummating transactions; exercising authority on behalf of the client; having custody of client assets; serving as a director or officer of the client; being a lender to the client; supervising client employees; and performing tax, bookkeeping, payroll, or consulting services.²⁶
- Adherence to AICPA's current independence rules generally requires that a member performing audit services for a given client not have performed certain non-audit services for that client during the period covered by the financial statements and during the period of the professional engagement (e.g., when performing the audit).²⁷ Prohibited non-audit services include performing management functions or making management decisions for the client; preparation or review of client financial statements or other documents that would be inputs to a subsequent audit; authorizing, executing, or consummating transactions on behalf of the client; exercising authority on behalf of the client; having custody of client assets; serving as a director or officer of the client; being a non-financial institution lender to the client; and supervising client employees.²⁸
- In general, a failure of independence due to an auditor's furnishing prohibited non-audit services to a client during the period covered by the financial statement or during the audit cannot be purged.²⁹ If, however, a failure of independence would result solely from a prospective auditor having a financial interest in a client (e.g., where the prospective auditor is an investor in or creditor of the client), the independence rule would be satisfied if the prospective auditor severed all financial interests in the client prior to commencement of the audit.³⁰

23. *Id.* at 3.

24. *Id.*

25. *Id.* at 4.

26. *Id.*

27. *Id.* at 6.

28. *Id.* at 6-7.

29. *Id.* at 8.

30. *Id.*

- Provided that the auditor complies with certain general requirements, the auditor may, under AICPA’s independence rule, provide other non-audit services such as performing tax, bookkeeping, payroll, or consulting.³¹
- AICPA intends to amend its Code so as to apply the independence rule to member networks.³² As amended, the Code would require that each member firm of an accounting network be independent of financial statement audit and review clients of the other firms in the network.³³ Thus, a network member may provide audit or review services for a client only insofar as other network members are not providing, and did not provide, during the period covering the financial statements, related, prohibited non-audit services for that client; and may provide prohibited non-audit services for a client only insofar as no other network member is then providing audit or review services.³⁴ As amended, the independence rule is intended to address an ethical issue arising from the increasing prevalence of accounting networks, ensuring the public that a firm providing an audit or review of a client’s financial statements will make required judgments in an objective manner without regard to how its judgments will affect the other network members.³⁵
- The proposed amended AICPA independence rule does not restrict any network member from competing with any other network member in the offering of audit or review services where no network member is providing, or recently has provided related, prohibited non-audit services to the same client; nor does it restrict any network member from competing with any other member in the offering of non-audit services where no network member is then providing audit or review services.³⁶
- Before taking on an audit or review engagement, a network member would have to learn from other network members or the prospective client whether any other network member has a prohibited relationship with the prospective client.³⁷ Thus, prior to providing audit or review services to a new client, a network member would have to

31. *Id.* at 7-8.

32. *Id.* at 5.

33. *Id.*

34. *Id.* “Related prohibited non-audit services” refers to prohibited non-audit services upon which a provider of audit services would or might have to rely in the provision of audit services in accordance with GAAS.

35. *Id.*

36. *Id.* at 6-8.

37. *Id.* at 8.

determine that no other network member was providing, or had recently provided related, prohibited non-audit services to that client; and prior to providing non-audit services to a new client, a network member would have to determine whether any other member was then providing audit or review services to that client.³⁸

- AICPA intends to issue guidance to its members urging them, in evaluating independence, to seek needed information from prospective clients to the greatest extent reasonably possible, and, where needed information can be obtained only from other network firms, to ask only whether the other network firms had potentially prohibited relationships with, or provided potentially prohibited non-audit services to, the prospective client.³⁹ The rule would not require the exchange among potentially competing firms of any information regarding a network member's bids, bidding strategy, capacity to bid, pricing or pricing plans, or other competitively sensitive information.⁴⁰
- The SEC requires that publicly-traded companies file audited financial statements with the agency that have been prepared by an accounting firm that adheres to SEC independence rules.⁴¹ The SEC also requires that broker/dealers submit audited statements prepared by accounting firms that adhere to the SEC independence rules, regardless of whether the broker/dealer is publicly traded.⁴²
- The SEC has determined that, to be effective, the audits filed with it must be independent both in fact and in appearance.⁴³ The SEC independence rule thus extends to all offices of an individual accounting firm, any subordinate units, and any affiliated entities, including any joint ventures or networks, including networks as defined by PEEC, to which the accounting firm may belong.⁴⁴
- AICPA seeks an opinion from FTC staff as to whether the application of the independence rule to networks raises significant antitrust concerns or would result in a

38. *Id.*

39. *Id.* See also Exhibit F to Hnatt Letter.

40. *Id.* See also Exhibit F to Hnatt Letter.

41. Interview with SEC officials, January 20, 2010.

42. *Id.*

43. *Id.*

44. *Id.*

staff recommendation to the Commission that the application of the rule in such a manner be challenged.⁴⁵

Bureau of Competition Analysis

The amended Code is aimed at the preservation of independence in the performance of audit services by a network member. The antitrust risks, if any, that may arise from blanket implementation of the amended Code across all AICPA member networks, regardless of the degree of integration or limits on competition that may be inherent in any given individual network, concern the degree to which the rule potentially further limits competition at the margin.

AICPA members are already subject to AICPA's independence rule on an individual basis. They are also subject to compliance with the SEC's independence rule, both individually and as part of any networks, to the extent they perform audits for publically-traded companies and for broker/dealers that will be filed with the SEC. Thus, were AICPA to amend its independence rule as proposed, the impact would be felt on accounting services for non-publicly-traded businesses and other entities that are not required to file audited financial statements with the SEC.

For these firms, application of the rule may reduce the number of AICPA members that would be able to bid for contemporaneous audit and prohibited non-audit work. Specifically, once the AICPA independence rule is expanded to cover networks, the individual members of that network may not compete for the audit work of a business during the time surrounding the provision of prohibited non-audit services to that same business by any single member of the network; nor may the individual members compete for the prohibited non-audit work of a business while any single member of the network is engaged to perform audit work for that same business. Such a situation could potentially significantly reduce competition in localized geographic markets in which there are few, if any, accounting competitors outside of the AICPA network. As a result, some local privately-held businesses seeking both audit and prohibited non-audit services could face higher bids because of the expanded independence rule.

As a general matter, the FTC recognizes that collaboration among competitors can be procompetitive when it results in cost-saving efficiencies or creates a new competitor. Collaboration, however, also may be anticompetitive if it eliminates one or more competitors or reduces incentives to compete. The joint FTC/DOJ Antitrust Guidelines for Collaborations Among Competitors provide the analytical framework for determining the net competitive effects of any given joint venture.⁴⁶

45. Hnatt Letter at 1.

46. See FTC/DOJ, Antitrust Guidelines for Collaboration Among Competitors (April 2000). Specifically, except where an agreement among competitors is *per se* unlawful, the agencies apply the "rule of reason" to assess competitor collaborations. In so doing, the agencies weigh any procompetitive effects of the collaboration against the potential for competitive harm. The agencies generally will not challenge collaborations where the net effect is competitively benign or procompetitive. Significantly, the Guidelines do not attempt to divide all collaborations into

Even assuming that existing AICPA member networks satisfy the “rule of reason” test, implementation of the expanded independence rule may, at the margin, tip the balance in the other direction. On the facts provided, however, it is not possible to make that determination for all potentially affected geographic markets. The analysis would depend on the number and size distribution of market participants, as well as on some measure of any integrative efficiencies appertaining to any given network of AICPA members.

Nonetheless, the potential for net competitive harm arising from expanding the AICPA independence rule to AICPA networks appears, based on the information presently available, to be small.⁴⁷ Audits of publically-traded companies are already covered by the stricter SEC independence rule. In addition, significant benefits to the capital markets, even respecting investors in non-publicly-traded businesses, can be expected to arise from AICPA’s adoption of an expanded independence rule to cover networks. Moreover, additional procompetitive benefits can be expected to the extent that AICPA networks are better able to compete against larger accounting firms for the business of larger privately-held clients. By contrast, potential anticompetitive consequences are speculative, occurring, if at all, most likely in localized geographic markets where there may be only a limited number of accounting firms available to compete for the accounting work of local businesses.

Network members seeking to comply with the expanded independence rule will need to obtain select information about recent and current engagements and activities of other network

procompetitive or anticompetitive lists. Rather,

the Agencies hope to assist businesses in assessing whether the Agencies will challenge a competitor collaboration or any of the agreements of which it is comprised. However, these Guidelines cannot remove judgment and discretion in antitrust law enforcement. The Agencies evaluate each case in light of its own facts and apply the analytical framework set forth in these Guidelines reasonable and flexibly.

Id. at 2 (citations omitted).

47. In *California Dental Ass’n v. F.T.C.*, 526 U.S. 756 (1999), the Court observed that, in the context of professional services where members of the public may not possess the specialized knowledge to evaluate the quality of provided services, the likelihood of net anticompetitive effects arising from ethical codes that otherwise restrict competition is not “comparably obvious” relative to restrictions in non-professional services situations. *Id.* at 771-772. For this reason, the Court held that a “quick look” rule-of-reason analysis is inappropriate in these instances. *Id.* at 780-781. On the one hand, the Court’s opinion suggests that AICPA’s expansion of its independence rule to cover networks may be a proper stand-in for lenders’ (assumed) inability to evaluate the quality of an audit of a non-publicly-traded business, thus enhancing economic value. On the other hand, the Court’s precise holding highlights the difficulty presented here, namely our inability to do more than render a “quick look” judgment about the likely competitive effects of the expansion of the independence rule, given the unavailability of facts required to assess the likely impact of the expanded independence rule on the lawfulness of particular networks in specific localized geographic markets.

members, and they might seek this information from other network members that are their potential competitors. The exchange among competitors of some kinds of information could itself result in anticompetitive outcomes in some markets, for example by reducing accounting firms' uncertainty as to the capacity or interest of other network members in competing for new clients. The reduction of uncertainty as to potential rivals' bidding intentions may, where only one or a few likely viable competitors remain, permit firms to increase bid prices for affected accounting services. The exchange of certain kinds of information among competitors may cause anticompetitive outcomes through other mechanisms as well.

Compliance with the expanded independence rule, however, will not require network members to seek from other network members any information about current or future capacity or bidding intentions. Moreover, in most instances a network member will be able to obtain the limited information needed to determine whether it may provide audit or prohibited non-audit services to a prospective client from the prospective client, with little or no risk to competition. AICPA intends to encourage the networks to do so, further reducing any risk of information sharing among network members that harms competition.

On balance, FTC staff has concluded that, although, in principle, there may be instances in which the expansion of the AICPA independence rule to networks reduces competition, the likelihood that the expanded rule would significantly reduce competition does not appear to be high. By contrast, the countervailing benefits of that expansion—in enabling small- and medium-sized accounting firms to increase their effective size and scope to compete for additional accounting work while ensuring the public that their audit work is untainted by auditor self-interest—appear substantial. On that basis, Commission staff has no present intention to recommend an enforcement action were AICPA to adopt the expanded rule. Having reached this conclusion, however, we note that its basis rests on incomplete facts respecting the specific geographic markets in which AICPA member networks do business. Therefore, although we do not at present intend to pursue further investigation, we also do not intend this Advisory Opinion to be construed as a blanket assessment that the expansion of the rule to networks could not raise competition concerns sufficiently great to induce future agency action. If more complete facts about individual networks come to light, or if the FTC receives specific complaints about higher bidding respecting individual AICPA networks because of the implementation of the expanded independence rule, our conclusion may change.⁴⁸

Conclusion

Based on the above, the Bureau does not intend to recommend a law enforcement action to the FTC at this time.

This letter expresses the current opinion of FTC staff, and is predicated on the accuracy of the information that you have provided to us. In accordance with normal practice, BC reserves the right to reconsider the questions involved and, with notice to the requesting party, to rescind the opinion if actual conduct in compliance with the Code proves to be anticompetitive

48. Additional facts, in this case, does not mean “changed” facts. It should also be understood that if known facts change, our conclusion could similarly be revised.

in any purpose or effect or if facts change significantly in the future such that it would be in the public interest to bring an enforcement action.

The views of FTC staff contained herein are provided as authorized by Rule 1.1(b) of the Commission's Rules of Practice, 16 C.F.R. § 1.1(b). Under Commission Rule 1.3(c), 16 C.F.R. § 1.3(c), the FTC is not bound by this staff opinion.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Bloom", with a long horizontal flourish extending to the right.

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