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Statement of

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Before

Economic Development Committee

Texas Senate

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This statement represents the views of the staff of the Federal Trade Commission's Bureau of Competition, and not necessarily those of the Commission itself or of any individual Commissioner.

Statement To

Economic Development Committee

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I appreciate the opportunity to be here today to discuss the restrictions on competition among accountants proposed in Texas Senate Bill No. 1269. This bill would amend the Texas Public Accountancy Act of 1979 to prohibit accountants' use of referral fees, contingent fees, and commissions.

My comments represent the views of the staff of the Federal Trade Commission's Bureau of Competition, and not necessarily those of the Commission itself or any individual Commissioner. The Commission, however, recently considered the validity under the federal antitrust laws of restrictions, similar to those proposed in S.B. No. 1269, that had been imposed by a private group of accountants on its members. On March 28, 1989, the Commission announced that it had accepted for public comment, Commissioner Azcuenaga dissenting, a consent agreement in which the American Institute of Certified Public Accountants agreed not to impose similar restrictions on its members.

Since the early 1970's, the Federal Trade Commission staff has been studying the effects of restrictions on the business practices of licensed professionals, including accountants,

lawyers, physicians and others. Our goal has been to identify restrictions that harm consumers by reducing competition without producing any countervailing benefits, such as higher quality services or enhanced consumer choice among service options. In general, we have concluded that certain kinds of restrictions on the ways in which professionals can market their services and set their prices are likely to lead to higher prices without offering any offsetting benefits to consumers.[1] We believe this is true of accountants, also.

S.B. No. 1269 appears intended to eliminate any potential for conflicts of interest to arise from accountants' financial arrangements with third parties that may affect their clients, or with their clients that may affect third parties. The avoidance of conflicts of interest is particularly important in the accounting profession because of the role accountants play in promoting the reliability of financial reporting. But restricting the dissemination of information about accounting services, and denying consumers pricing terms and service options

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[1] Jacobs *et al.*, *Improving Consumer Access to Legal Services: The Case for Removing Restrictions on Truthful Advertising*, Cleveland Regional Office and Bureau of Economics, Federal Trade Commission (1984); Bond, Kwoka, Phelon, and Whitten, *Effects of Restrictions on Advertising and Commercial Practice on the Professional: The Case of Optometry*, Bureau of Economics, Federal Trade Commission (1980); Muris & McChesney, *Advertising and the Price and Quality of Legal Services: The Case for Legal Clinics*, 1979 Am. B. Found. Research J. 179 (1979); McChesney & Muris, *The Effects of Advertising on the Quality of Legal Services*, 65 A.B.A. J. 1503 (1979); Cady, *Restricted Advertising and Competition: The Case of Retail Drugs* (1976); Benham and Benham, *Regulation Through the Professions: A Perspective on Information Control*, 18 J.L. & Econ. 421 (1975).

that they want, may limit consumer choice more severely than is reasonably necessary to address potential conflicts of interest. There are less restrictive means of assuring the independence of auditors and the availability of objective financial advisors.

The Texas Board of Public Accountancy, several other state boards of accountancy and the American Institute of Certified Public Accountants have recently abandoned their prohibitions of referral fees, contingent fees and commissions in favor of the less restrictive alternatives of (1) requiring that referral fees and commissions be disclosed, and (2) limiting accountants' use of contingent fees and commissions to services for clients for whom they do not provide attest services.[2] The National Association of State Boards of Accountancy has proposed a Model Code for adoption by its member state boards of accountancy that takes the same approach.[3]

We believe that prohibiting the use of referral fees, contingent fees and commissions by accountants would not be in

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[2] By "attest services," we mean an accountant's report that states or implies some degree of assurance as to the reliability of any financial statement; such services include audits, reviews and some compilations. "Nonattest services" refers to all other services offered by accountants, including tax, management advisory, reimbursement, and financial planning services.

[3] Although many state accountancy boards still restrict accountants' use of referral fees, contingent fees and commissions, these restrictions are subject to scrutiny under the antitrust laws unless the state legislature has clearly articulated and affirmatively expressed the intent to supplant these kinds of competition. Only one state, Iowa, has statutory prohibitions on referral fees, contingent fees and commissions. The only other states that have statutory prohibitions are California (prohibits referral fees and commissions) and Florida (prohibits contingent fees).

the public interest. These prohibitions would be more restrictive of competition than is reasonably necessary to protect consumers against conflicts of interest. We believe that the less restrictive alternative of requiring that referral fees and commissions be disclosed is a preferable means of ensuring that consumers have sufficient information to protect themselves against conflicts of interest. And the less restrictive alternative of limiting the use of contingent fees and commissions to nonattest clients is a preferable means of ensuring that accountants remain independent when they provide attest services.

Referral Fees

S.B. No. 1269 would prohibit accountants from paying "compensation . . . to solicit or secure a prospective client."[4] This provision would prevent accountants from using a potentially effective means of making consumers aware of their services. Some accountants, for example, would like to pay referral fees to marketing firms to disseminate information about their services. Other accountants would like to pay referral fees in the form of discounts to clients for referring new clients.

We believe that referral fees, like expenditures for advertising, are likely to increase competition among accountants by increasing the dissemination of information about accounting

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[4] S.B. No. 1269, § 1(a)(1).

services to consumers. By making more information about accountants available to consumers, referral fees may reduce consumers' costs of searching for accountants whose services are appropriate to their particular needs. This in turn places competitive pressure on accountants to provide the services consumers want at prices they are willing to pay. Referral fees also provide an incentive that might encourage some accountants to refer potential clients to other accountants who have greater expertise in providing the particular services needed, and who could presumably provide higher quality services. Banning referral fees, therefore, may lead to increased prices and reduced quality of accounting services, with reduced satisfaction of consumer needs and preferences.

Proponents of a ban on referral fees argue that accountants who pay them will have to increase their fees in order to pass on the cost of referral fees. We do not believe this is a valid concern. First, referral fees, like any marketing expenditure, are intended to build a larger client base and thus to reduce the cost of serving each client. To the extent that the cost of serving each client can be reduced, accounting fees are likely to decline rather than to increase. Second, prohibiting the payment of referral fees is likely to cause accountants to use other, less efficient means of promoting their practices. To the extent that this happens, the cost of serving each client will be higher than it would with more efficient marketing methods, and accountants will therefore be likely to charge higher fees.

Finally, if accountants refer clients to other accountants with greater expertise in the services desired, the time necessary to provide such services may be reduced, and accordingly the total fees for them may be lower.

Supporters of a ban on referral fees also assert that such arrangements may deceive consumers. That is, the payment of a referral fee may provide the incentive for an inappropriate referral, not to the most appropriate accountant, but rather to the accountant who pays (or pays the highest) referral fees. The fact that a referral fee is paid may therefore be material to a consumer's assessment of the appropriateness of a referral, and withholding this material fact may amount to deception.

A ban on referral fees, however, is more restrictive of competition than is reasonably necessary to prevent any deception that might otherwise occur. The less restrictive alternative of requiring disclosure of referral fee arrangements to consumers would enable them to make informed choices. If for any reason a consumer preferred to deal with an accountant who does not pay referral fees, disclosure would preserve that option. Accounting regulators increasingly appear to favor this approach. The Texas Board of Public Accountancy currently permits the use of referral fees if they are disclosed.[5] State accountancy boards in Maryland, Oklahoma, and West Virginia, and the American Institute of Certified Public Accountants also permit disclosed referral

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[5] Rules of Texas State Board of Accountancy, Code of Ethics, § 501.13.

fees, and the National Association of State Boards of Accountancy has proposed a Model Code permitting disclosed referral fees for adoption by its member state boards of accountancy.[6] We therefore believe that a ban on referral fees, as proposed in S.B. No. 1269, would be likely to result in a smaller net benefit for consumers than would permitting accountants to use referral fees, subject to an appropriate disclosure requirement.

Contingent Fees

S.B. No. 1269 would prohibit accountants from providing services "for a fee that is contingent on the findings or results of the services . . . ."[7] This provision would limit consumer choice as to the method of paying for accounting services. Consumers in Texas would be prevented from agreeing with an accountant that the fee will be a percentage of any refund or reimbursement obtained. For example, businesses that need accounting firms to review taxes paid in the past and file amended returns to obtain any appropriate refunds would not be able to make payment contingent upon the amount recovered.

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[6] National Association of State Boards of Accountancy, Model Code of Professional Conduct, Rule 104 (March 1989). The state accountancy boards in Maryland and West Virginia do not have any restrictions on referral fees.

[7] S.B. No. 1269, § 1(a)(2). There are two exceptions: services related to taxes, in which the findings are made by a taxing authority; and services for which the amount of the fee is indeterminable at the time the services are rendered because the fee will be fixed by a public authority, including a court, or other third party.

State, county, or municipal hospitals that need an accounting firm's assistance to obtain Medicare reimbursement from the federal government, but are forced by budgetary constraints to pay accounting fees out of any amount recovered, would have to forego reimbursement.

A contingent fee restriction helps to insulate established accountants from competition. Offering to provide tax refund services, for example, on a contingent fee basis may be an attractive inducement to potential clients to purchase a different accountant's services. Indeed, a contingent fee may be the only basis on which a prospective client would hire a new accountant to identify and pursue tax refund claims, when the tax previously had been calculated by another accountant. And by providing services to new clients on a contingent fee basis, an accountant may be able to demonstrate the quality of his services and thus obtain additional business from those clients.

In addition to promoting competition among accountants, contingent fees can directly benefit consumers in a variety of ways. By indicating a willingness to undertake a project on a contingent fee basis, an accountant informs the client that the accountant is reasonably confident the project will succeed, for the accountant's compensation depends upon success. A contingent fee arrangement also shifts to an accountant a portion of the risk of the project, because the accountant's fee will depend upon the amount recovered. Finally, to the extent that the likelihood of success increases as the quality of accounting

services increases, a contingent fee may induce higher quality services because the accountant's fee depends upon success.

Thus, a restriction on contingent fees would be likely to insulate accountants from an important form of competition; increase consumers' costs by reducing their information about the likelihood of success of accounting services and restricting their ability to share with accountants the risk of failure; and eliminate an incentive for accountants to provide high quality services. The economic effects of this restriction are likely to be higher priced and lower quality accounting services in Texas, with reduced satisfaction of consumer needs and preferences.

Proponents of a ban on contingent fees argue that prohibition of this method of payment is necessary to preserve accountants' independence and objectivity. Prohibiting contingent fees with respect to attest services, and to clients for whom an accountant provides attest services, may benefit consumers by promoting auditors' independence and objectivity, which are essential to the reliability of financial reporting. But prohibiting contingent fees in connection with nonattest services, such as Medicare reimbursement assistance and tax refund assistance, provided to clients for whom an accountant does no attest work, is unnecessary. In providing these services, the profession, as well as third parties such as HHS and the IRS, recognizes that accountants serve as advocates. Certainly, a client hardly expects his tax accountant to be "independent" or "objective," but rather expects his accountant

to advocate his interests to the fullest extent possible under the law.

The Texas Board of Public Accountancy,[8] the state accountancy board in Oklahoma, the Model Code proposed by the National Association of State Boards of Accountancy,[9] and the American Institute of Certified Public Accountants permit accountants to use contingent fees when they provide services to a client for whom they are not also providing attest services.[10] The state accountancy boards in Massachusetts and South Dakota also permit accountants to use contingent fees in some circumstances.

We therefore believe that consumers are better served if accountants are allowed to use contingent fees for services they provide to clients for whom they do not provide attest services. This less restrictive regulation of contingent fees appears sufficient to protect consumers against conflicts of interest.

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[8] Rules of Texas State Board of Accountancy, Code of Ethics, § 501.11(c)(4).

[9] National Association of State Boards of Accountancy, Model Code of Professional Conduct, Rule 101 (b)(4) (March 1989).

[10] The Texas Board permits accountants to use contingent fees for nonattest services provided to an attest client, if the amount of the contingent fee is not material with respect to the total fees paid by the client.

Commissions

S.B. No. 1269 would prohibit accountants from receiving "compensation for recommending or referring the product or service of another person to a client . . . ."[11] This restriction would prevent an accountant and his client from agreeing that the accountant's only compensation for preparing a financial plan will be the commissions received if the client decides to purchase any recommended investments. It would also prevent an accountant and client from agreeing that the accountant's only compensation for recommending necessary computer equipment and software comprising a financial reporting system will be the commissions paid on the sale of the computer products. The need for the restriction in the computer example is particularly puzzling, since there is no restriction that would prevent an accountant from buying and reselling computer equipment to a client for a profit.

A ban on commissions would inhibit competition among accountants. Since tax services constitute a substantial portion of the business of many accounting firms, activities aimed at securing tax business are an important means of competition among accountants. And because financial planning services may sometimes be supplied most efficiently if they are provided together with tax services, accountants can compete to obtain tax business by offering to provide financial planning services at

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[11] S.B. No. 1269, § 1(a)(3).

little extra cost. However, under the bill's restriction on commissions, this might not be economically feasible.

We have learned in the course of our investigation leading to the AICPA consent order that some Texas consumers want to be able to obtain commission-based financial planning services. Some Texas accountants have attracted new tax clients from other accountants by offering commission-based financial planning, and they now provide all of their new clients' financial planning, tax, and other accounting services. Other Texas accountants believe that if they did not provide commission-based financial planning services, many of their existing clients would take their tax and other business to another accountant who would do so. As the use of commission-based financial planning increases, accountants who provide financial planning services on a fee basis may be forced to reduce their fees in response to competition from accountants who provide commission-based financial planning.

Direct consumer benefits, similar to those provided by contingent fees, can result when accountants are allowed to receive commissions on, for example, the sale of financial products to clients. A consumer may desire an accountant's assistance in preparing a financial plan, but wish to pay for it only if he believes it will be useful. If the accountant is willing to undertake preparation of a plan in the expectation of being compensated only through commissions on the sale of investments, and the commission arrangement is disclosed to the

client, the accountant communicates to the client his belief that the plan will be useful. Commissions also allow the accountant to shoulder the risk that the client may not be persuaded the plan is useful, since the accountant will not be compensated unless the client decides to implement the plan. Moreover, the better the financial plan (as measured by the client's decision to implement its recommendations), the more likely it is that the accountant will receive commissions. Thus, the commission arrangement provides an incentive for the accountant to provide higher quality services.

Consumers enjoy an additional benefit where accountants can use commissions: the option of one-stop shopping for financial planning services. Some consumers prefer to have their accountant both prepare a financial plan and implement it by recommending and arranging the purchase of investments. The ban on accountants' receipt of commissions proposed in S.B. No. 1269, however, would prevent accountants who have prepared financial plans from implementing them. Preparation of financial plans, which generally provide an outline of the steps necessary to achieve the client's goals, requires considerable research and analysis. If accountants are prohibited from accepting commissions, the only way they can be adequately compensated for preparing financial plans is by charging a substantial fee. Consumers would either have to forego using an accountant's financial planning services or bear the cost of both financial planning services and commissions on purchases of investments.

In addition, consumers would lose the convenience of dealing with only one professional, which saves the time and effort that are necessary to establish knowledgeable, trusting relationships with multiple advisors.

The bill's restriction on commissions is thus likely to have much the same effects on consumers as the contingent fee restriction. The restriction would reduce competition among accountants; increase consumer costs, because they would receive less information about accounting services and assume greater risks; and eliminate an incentive to provide higher quality services. The result is likely to be an increase in the price and a reduction in the quality of accounting services in Texas, with a reduction in the satisfaction of consumer needs and preferences.

Proponents of a ban on commissions raise the same argument that they make against contingent fees, that is, prohibition is necessary to preserve accountants' independence. Our views, discussed earlier with respect to contingent fees, apply with equal force to commissions -- independence concerns are met by permitting accountants to receive commissions only for services provided to nonattest clients. The Texas Board of Public Accountancy,[12] the state board of accountancy in Oklahoma, the Model Code proposed by the National Association of State Boards

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[12] Rules of Texas State Board of Accountancy, Code of Ethics, § 501.11(c)(3).

of Accountancy,[13] and the American Institute of Certified Public Accountants permit accountants to receive commissions in connection with services provided to a client for whom the accountant performs only nonattest services.[14] The state accountancy board in Maryland does not have any restriction on commissions, and the state accountancy board in South Dakota permits accountants to receive commissions in some circumstances.

It has also been argued that prohibiting the receipt of commissions for recommending products or services to nonattest clients is justified because commissions can create a conflict of interest and loss of objectivity. The concern is that accountants might recommend services or products that clients do not need or that are less valuable to consumers than other services or products that would produce lower commissions.

We believe that commissions need not be banned in order to prevent such abuse. During the course of our investigation that led to the AICPA consent order, we learned that accountants who wish to respond to consumer demand for commission-based financial planning services are likely to promote their services by informing consumers that they receive commissions. We also learned that accountants who provide financial planning services

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[13] National Association of State Boards of Accountancy, Model Code of Professional Conduct, Rule 101(b)(3) (March 1989).

[14] The Texas Board of Public Accountancy permits accountants to receive commissions in connection with nonattest services provided to an attest client, if the amount of the commissions is not material with respect to the total fees from the client.

on a fee basis are likely to inform consumers through their advertising that fee-based financial planning is an alternative to commission-based financial planning. Consumers are therefore likely to become aware of their options and to question their accountant about his method of compensation. Businesses that purchase products recommended by accountants are likely to be aware of their options. Thus, consumers who prefer to deal with an accountant who does not accept commissions will have the opportunity to do so.

The Texas Board of Accountancy requires accountants to disclose, when they recommend products or services, that they accept commissions from third parties.[15] The state accountancy board in Oklahoma and the National Association of State Boards of Accountancy's proposed Model Code take this approach as well.[16] This approach also affords consumers the opportunity to make an informed choice between fee-based and commission-based financial planning services.

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[15] Rules of Texas State Board of Accountancy, Code of Ethics, § 501.14.

[16] National Association of State Boards of Accountancy, Model Code of Professional Conduct, Rule 103 (March 1989). Competition also provides a significant disincentive for exploitive behavior by accountants. Since accountants depend heavily on client referrals as a method of obtaining new business and on repeat business from existing clients, there are strong incentives for them to make appropriate recommendations to their clients. State licensing board discipline and potential law suits by injured clients provide further incentives to make appropriate recommendations.

Accordingly, we believe that consumers would be better served if accountants are permitted to use commissions in connection with services provided to nonattest clients. If the Committee believes mandatory disclosure is needed, it may want to consider amending S.B. 1269 by adding an appropriate disclosure requirement.

Conclusion

In summary, we believe that S.B. No. 1269 in its present form would impose restrictions on competition among accountants and on the dissemination to consumers of information about accounting services that are likely to reduce consumers' ability to obtain accounting services on terms they want, without providing any countervailing benefits. The Committee may therefore want to consider amending the bill so as to permit accountants to pay referral fees, with appropriate disclosure, and consumers to enjoy the benefits of using contingent fees and appropriately disclosed commissions as methods of payment for accounting services.