ALERT

Private Equity and Auditor Independence

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The Securities and Exchange Commission and the Public Company Accounting Oversight Board have expressed renewed focus on public accounting firms' obligations to create and maintain a culture of professional ethical behavior and auditor independence in fact and in appearance.

In particular, the regulators have expressed concern, and offered some guidance to, accounting firms that are considering restructuring, particularly when it involves private equity and divestitures of portions of the accounting firm's business, and the elevated risk to auditor independence that such transactions present and firms need to evaluate and continually monitor.

More firms have shown an interest in this type of investment to take advantage of capital infusion to fund long-term growth plans (particularly in the consulting, advisory and outsourcing sectors), to invest in technological innovation, and to capitalize on increased and accelerated profitability by offering expanded services to a broader client base.

Because audit firms cannot be majority owned by non-CPAs, these private equity transactions often involve splitting an accounting firm into separate entities — one entity owned by CPA partners that provides attest services, and another entity wholly or majority owned by non-CPA private equity partners that provides non-attest services such as tax, technology or consulting services. But splitting a firm is no simple task and requires lots of planning, consultation, and due diligence, particularly as it relates to the issue of compliance with auditor independence requirements.

According to regulators who recently spoke at the May 2023 ALI CLE Accountant's Liability Conference, they are concerned that private equity firms and other third parties that have not previously been subject to the same duties and responsibilities as public accounting firms may not be familiar with the independence requirements. The regulators have also expressed concern that accounting firms have not fully evaluated the current and future impact of becoming part of a complex business structure and how it may impact auditor independence.

In view of these regulatory concerns, it is not surprising that the PCAOB has identified auditor independence as a staff priority for its 2023 inspections. In particular, the board will continue to focus on the following:

- The adequacy of the accounting firm's monitoring of independence throughout the audit and professional engagement period, including consideration of a firm's violation of its own policies and procedures for possible quality control concerns;
- Whether the firm is in compliance with rules for permissible, significant non-audit services, as well as required preapproval, including communications with audit committees concerning independence; and,

- How firms manage risks related to independence in the creation of alternative practice structures.

As part of the inspection process, the PCAOB said that inspection teams will conduct sweeps around independence topics, publicly disclose the number of independence rules violations and potential non-compliance with SEC independence rules in Part 1C of inspection reports, and determine if any independence quality control concerns from past inspections are ongoing and/or were ineffectively remediated.

Likewise, it seems clear that the SEC and Office of the Chief Accountant staff are focused on auditor independence and the critical role it has in ensuring auditor integrity and fulfilling public auditors' gatekeeping function. They also conveyed an intolerance for those accounting firms that violate auditor independence requirements in pursuit of their financial interests and efforts to grow non-attest services in search of private equity restructuring and profit.

It is further clear that the SEC and PCAOB believe transactions with investors that are not traditional accounting firms elevate the risk of impairment to an auditor's independence: "In these complex practice structures and divestitures, it is paramount that the accounting firm fully understands its responsibility for maintaining auditor independence and it discloses such requirements to the non-accounting firm investors involved in the transaction so that the accounting firm can obtain the information necessary to fulfill its responsibilities."

What Counts as Part of a Firm?

It is important to note that pursuant to Rule 2-01 of Regulation S-X under the Securities Act of 1933, "accounting firm" includes "the organization's departments, divisions, parents, subsidiaries and *associated entities* [emphasis added], including those outside of the United States" and the organization's pension, retirement, investment, or similar plans.

The SEC cautions that an accounting firm considering private equity investment must evaluate whether each entity in the structure is an "associated entity" and subject to the commission's auditor independence requirements. The determination of whether an entity will be considered an "associated entity" focuses on whether a reasonable investor would believe the entity has a financial interest in the accounting firm, or influence over the accounting firm because it is a holder of an ownership interest or through the entity's ability to control or influence a holder of an interest. Additionally, the accounting firm should consider whether there are any individuals investing directly into the accounting firm who would be considered a "covered person" under the definition of Rule 2-01.

Consequently, it is critical that accounting firms design and implement processes and procedures to conduct due diligence and ongoing monitoring of the entity structure and investor ownership interests and influential relationships.

Beyond considering the private equity transaction structure and whether and which entities and persons may be subject to the commission's auditor independence requirements, there are certain services that the OCA staff has strongly signaled will not likely meet such requirements. These include those which present potential mutual or conflict of interest concerns in fact or in appearance. "[I]t is the view of OCA staff that it would be a high hurdle for the accounting firm to be in compliance with Rule 2-01(b) of Regulation S-X … if it provides *any* audit, review, or attestation services with a nexus to the commission's independence requirements for *any* entities within the private equity structure."

Firms should consider whether there are any private portfolio companies within the private equity structure for which the accounting firm currently provides auditing services, and the potential or likelihood that one or more of them may go public in the future, along with the risk the auditing firm may be precluded from continuing to perform auditing services for those entities due to independence issues. This is something that the accounting firm should discuss with its private entity clients and plan for in advance of the restructuring.

Firms should closely evaluate and monitor auditor independence and the private equity structure at the time of the initial private entity investment, as well as post transaction in light of the changing ownership and entity structuring which is a foundational part of the private equity business model.

Divestitures

The SEC has also provided some guidance regarding appropriate independence issues and actions that should be considered in divestiture transactions. The OCA staff expects that, post -transaction, the accounting firm and the divested entity should, at a minimum:

- Adopt separate corporate governance, management and financial structures;
- Terminate all interests between the accounting firm and the divested entity;
- Not have any revenue or profit-sharing between the accounting firm and the divested entity;
- Not have any co- or joint-marketing agreements or advertising arrangements (or equivalent) between the accounting firm and the divested entity;
- Prohibit the divested entity and its affiliates from profiting from the accounting firm's name or logo prospectively; and,
- Complete promptly any transition-related shared services between the accounting firm and divested entity.

While the spun-off entity may want to leverage the name and reputation of the public accounting firm, it is important to note that similar branding of an entity that was spun off can present a risk of running afoul of the requirement that there not only be independence in fact, but also independence in "appearance." Such matters should be considered and discussed with potential non-accountant investors before the transaction is consummated.

While accounting firms continue to explore private equity investment opportunities, it is important to have processes and procedures in place to conduct the necessary legal and technical due diligence to fully consider and monitor independence considerations. Some key issues to monitor are the entity structure, ownership interests, permissible non-audit services and required audit committee approval, and the impact of future private equity investment transactions and changes to related entity portfolio companies.

Implications on Risk Transfer Mechanisms

Given the heightened attention by regulators to these types of transactions, firms should also consider the potential impact on their traditional risk transfer mechanisms like insurance.

With respect to insurance risk transfer, accounting firms should start by identifying the insurance products within their insurance portfolio that would be most relevant — such as the firm's professional liability insurance policy.

In reviewing and evaluating such policies, firm's should consider some of the following: adequacy of limits, scope of coverage for regulatory actions, impact on the firm's risk profile from an underwriting perspective, if there is claim activity, and how each of these considerations impacts negotiated insurance terms and resulting premiums. An experienced insurance broker or advisor can assist firms in conducting this sort of analysis.

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