

# SEC auditor independence considerations: When a private equity portfolio company is considering an initial public offering

July 2024

## Introduction

If a private equity fund portfolio company is considering an initial public offering (IPO) as a possible exit strategy, U.S. Security and Exchange Commission (SEC) auditor independence rules should be considered well in advance of the IPO. Proper application of SEC auditor independence rules is required for all audited periods presented in financial statements filed with the initial registration statement. The number of years of financial statements that must be audited will depend on the specific registration form used. If the portfolio company has been in existence for more than two years, the financial statements presented generally would include balance sheets as of the end of the two most recently completed fiscal years and statements of income, shareholders' equity and cash flows for each of the past three fiscal years. Certain IPO registration statement rules for smaller reporting companies and emerging growth companies (as defined), if available to the portfolio company, allow presentation of statements of income, shareholders' equity and cash flows for only the last two fiscal years.

These requirements create a look-back period of two or three years where the auditor needs to reassess its independence under SEC rules with respect to the portfolio and its affiliates. The SEC has stated that auditors should anticipate IPOs by private equity portfolio companies and is becoming less inclined to allow independence violations during the look-back period. Therefore, it is important that both private equity management and the management of all portfolio companies be aware of the following SEC independence considerations.

## Defining the audit firm

The SEC defines “accounting firm” as an organization that is engaged in the practice of public accounting and furnishes reports or other documents filed with the SEC or otherwise prepared under the securities laws, and all of the organization’s departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. For example, RSM US LLP is the U.S. member firm of RSM International, a global network of independent accounting, tax and consulting firms. Under the SEC’s rules, RSM International and its member firms are considered to be “associated entities” of our firm. Therefore, when assessing independence, we are required to evaluate the client relationships of our firm and the other RSM International member firms as if we are one entity.

## Defining the audit client

The SEC defines “audit client” as the entity whose financial statements are being audited, reviewed, or attested and any affiliates of the audit client. “Affiliates of the audit client,” as defined by the SEC, include:

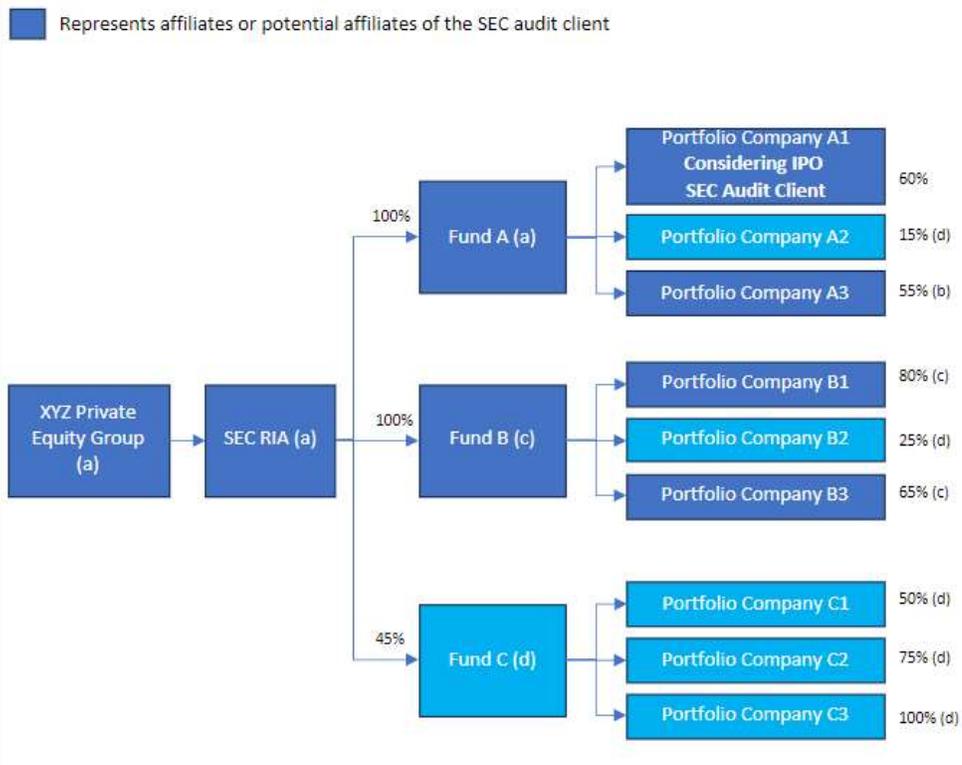
- An entity that has control over the entity under audit, or over which the entity under audit has control, including the audit client’s parents and subsidiaries

- 
- An entity that is under common control with the entity under audit, including the entity under audit's parents and subsidiaries, when the entity and the entity under audit are each material to the controlling entity;
  - An entity over which the audit client has significant influence, unless the entity is not material to the audit client;
  - An entity that has significant influence over the audit client, unless the audit client is not material to the entity
  - Each entity in the investment company complex when the entity under audit is an investment company or investment adviser or sponsor

When applying this definition, the following should be noted:

- Control is presumed if there is more than 50 percent ownership interest. Control also may exist when there is less than 50 percent ownership interest if there are other conditions through which control could be exercised, e.g., board rights, veto rights, a contract, etc. Majority representation on a board of directors (or equivalent) will always constitute control.
- Significant influence is presumed if there is 20 percent or more ownership interest but less than 50 percent ownership interest or if board rights or similar features are 20 percent or greater but less than 50 percent.
- With respect to measuring materiality of an entity to an owner or investor in that entity, any amount equal to or greater than 5% of either the investor entity's net assets or income from continuing operations before income taxes (increase in net assets for entities applying fair value accounting) is presumed material. For non-investor entities such as investment advisers, amounts equal to or greater than 5% of assets under management or management fee revenue are presumed material. If an investment is not yet material, consideration should be given to the likelihood that an affiliate may become material because of changes in the value of the investee.

With limited exceptions, when assessing independence, the auditor must look at any services for or relationships with the client and the affiliates of the audit client as if they were one entity. This affects not only the services auditors are allowed to provide to the portfolio company that is considering an IPO but also the services they are allowed to provide to the investing fund. Additional consideration would also need to be given to other portfolio companies controlled by the investing fund and all other private equity funds under common control and portfolio companies under their control to determine if they meet the affiliate definition. As illustrated in the following diagram, the SEC rules will be applied to the auditor's relationships with all entities determined to be affiliates. The extent to which the non-audit service rules apply depends upon the relationship between the audit client and its affiliate.



- (a) The entity has control over the audit client and is therefore deemed an affiliate of the audit client.
- (b) This entity is under common control with the audit client. This entity and the audit client would be affiliates of one another if both were material to the entity that controls both (Fund A).
- (c) This entity is under common control with the audit client. This entity and the audit client would be affiliates of one another if both were material to entity that control both (SEC RIA).
- (d) The entity is not under common control with the audit client and is therefore **not** deemed an affiliate.

### Prohibited services

The SEC requires auditors to be independent of their audit clients both in fact and in appearance. In considering an auditor's independence, the SEC looks to four overarching principles—whether a relationship or the provision of a service:

- Creates a mutual or conflicting interest between the accountant and the audit client
- Places the accountant in the position of auditing his/her own work
- Results in the accountant acting as management or an employee of the audit client
- Places the accountant in a position of being an advocate for the audit client



Accordingly, the SEC sets forth restrictions on an auditor providing certain non-audit services to an audit client and its affiliates. Rule 2-01 of SEC Regulation S-X specifically prohibits the following services from being performed by the auditor for the audit client and its affiliates:

- Bookkeeping or other services related to the audit client's accounting records or financial statements, e.g., preparing financial statements or tax provisions and providing valuation or tax provision templates
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit services
- Management or human resources functions, e.g., executive searches
- Broker-dealer, investment adviser, or investment banking services
- Legal and expert services unrelated to the audit, e.g., litigation support

It is typical that individual portfolio companies use public accounting firms to provide non-audit services to assist them in addressing a wide variety of issues. For example, auditors commonly are asked to provide non-audit services, such as preparing financial statements or tax provisions, providing valuation or tax provision templates, and assisting with financial information systems implementation. As discussed above, providing non-audit services to an audit client or its affiliate can pose a problem for auditor independence.

### **“Not subject to audit” exception**

Language in certain SEC rules states independence is impaired unless “...it is reasonable to conclude that the results of the services will not be subject to the audit procedures of the auditor during its audit of the audit client's financial statements.” This “not subject to audit” exception can be applied to brother/sister entities of a portfolio company that is considering an initial public offering provided the results of the service would not be subject to audit. It should be noted, however, that the “not subject to audit” exception is not available to any entities that are downstream affiliates of an audit client subject to SEC independence rules, regardless of whether the fund's auditor audits the downstream affiliates.

Rules that include the “not subject to audit” exception are those governing the following prohibited services:

- Bookkeeping or other services related to the audit client's accounting records or financial statements, e.g., preparing financial statements or tax provisions and providing valuation or tax provision templates
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit services

The “not subject to audit” exception cannot be applied to the following prohibited services:

- Management functions, such as providing managed services or hosting services
- Human resources functions, such as executive searches

- 
- Loaned staffing arrangements
  - Investment advisory services
  - Legal services
  - Expert services, such as litigation support
  - Broker-dealer/investment adviser/investment banking

## Conclusion

Maintaining auditor independence in a private equity environment can be particularly challenging given the significant number of entities under common control. Therefore, it is important that there be effective two-way communication between the auditor and portfolio company management regarding matters such as non-audit services. It is equally important that there be effective two-way communication between the portfolio company, its brother/sister portfolio companies, and private equity fund management regarding these matters. Please contact your RSM audit engagement partner for answers to questions regarding the application of SEC auditor independence rules to your specific situation.

**+1 800 274 3978**  
**rsmus.com**

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit [rsmus.com/aboutus](https://rsmus.com/aboutus) for more information regarding RSM US LLP and RSM International.

RSM, the RSM logo and *the power of being understood* are registered trademarks of RSM International Association.

© 2024 RSM US LLP. All Rights Reserved.

