SEC auditor independence considerations: When a private equity fund audit client has a registered investment adviser

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Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires most advisers of private funds to register with the U.S. Securities and Exchange Commission (SEC) as investment advisers and to comply with the Investment Advisers Act of 1940. The registration requirement generally applies to Investment Advisers who have $150 million or more in aggregate assets under management in the United States. Under this regulatory framework, a general partner of a private equity fund or a manger of a limited liability company is likely deemed to have custody of assets maintained in a private equity fund because the general partner/manager has the authority and the ability to transfer the assets or obtain possession thereof without the consent of the limited partners/members.

The SEC requires registered investment advisers to maintain certain safeguards to maintain all securities at a qualified custodian. One of the safeguards required under Dodd-Frank is that the registered investment adviser is subject to surprise examinations. The surprise examinations are required to be conducted by a firm that is registered with the Public Company Accounting Oversight Board (PCAOB) and must be conducted under the independence requirements of the SEC. There is an exception to the surprise examination requirement for the registered investment adviser if:

- The fund that it manages is audited by a PCAOB-registered and inspected auditor
- That auditor is independent under SEC Regulation S-X
- The fund issues financial statements prepared in accordance with U.S. generally accepted accounting principles (with an unqualified opinion) to its investors within 120 days (180 days for “fund of funds") after its fiscal year end

Many private equity firm advisers take advantage of this exception and therefore the funds are required to be audited. As a result, the fund's auditor needs to be registered with and inspected by the PCAOB, and the audits are subject to SEC independence rules. Therefore, it is important that the registered investment adviser, private equity fund 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. Accounting firm also includes the organization’s pension, retirement, investment or similar plans. 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 client 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

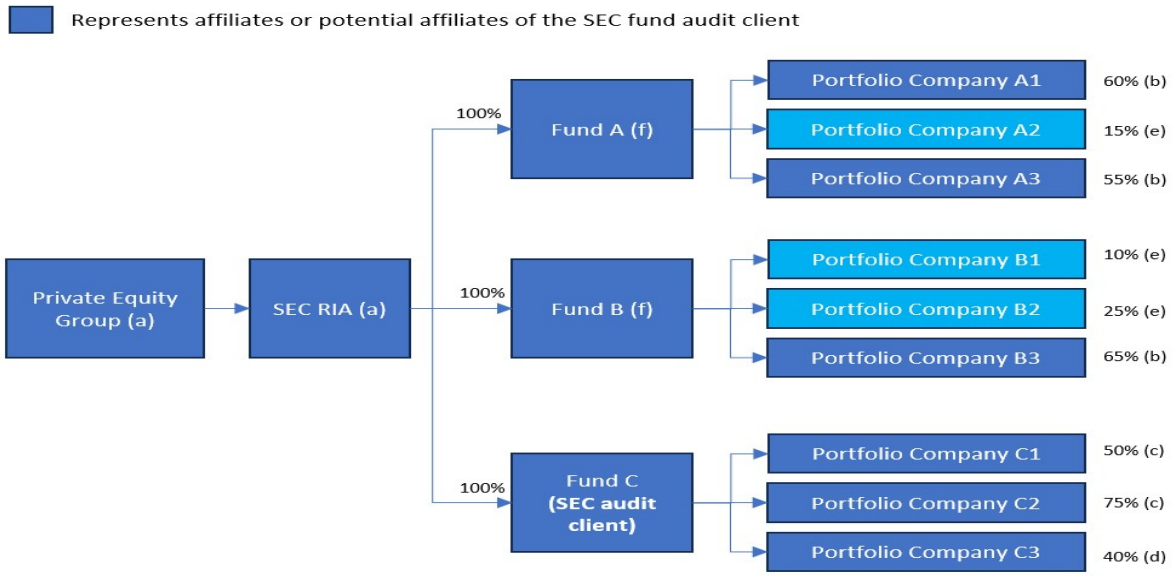
When the entity under is an investment company complex (e.g., a private equity fund with a registered investment adviser), affiliates within the investment company complex include:

1. The investment company under audit and its investment adviser or sponsor;
2. Entities controlled by or controlling the investment company under audit;
3. Entities controlling the investment adviser or sponsor of the investment company under audit;
4. An entity controlled by the investment adviser or sponsor of the investment company under audit if the controlled entity and the investment company under audit are each material to the investment adviser or sponsor;
5. An entity controlled by the investment adviser or sponsor of the investment company under audit if the entity provides administrative, custodial, underwriting or transfer agent services to the investment company under audit or its investment adviser or sponsor;
6. Investment companies, investment advisers or sponsors under common control with any of the entities in 1 through 5 if the entity and the investment company under audit are each material to the controlling entity;
7. All entities under common control with any of the entities in 1 through 5 that provide administrative, custodial, underwriting or transfer agent services to either the investment company under audit or its investment adviser or sponsor;
8. Any entity over which the investment company under audit has significant influence unless the entity is not material to the investment company under audit and any entity that has significant influence over the investment company under audit unless the investment company under audit is not material to the entity that has significant influence over it; and
9. Any investment company whose investment adviser or sponsor is an affiliate of the investment company under audit other than by virtue of item 8.

When applying the SEC's definition of "audit client," 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 fund audit client but also the services they are allowed to provide to all portfolio companies controlled by the audited fund. Additional consideration would also need to be given to 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 common controlling entity (SEC RIA).

(c) The entity is one over which the audit client has control and is therefore deemed an affiliate of the audit client.

(d) The entity is one over which the audit client exercises significant influence and would be an affiliate of the audit client and entities upstream from the audit client, if material to the audit client.

(e) The entity is not under common control with the audit client and is, therefore, not deemed an affiliate.

(f) The entity is an investment company under common control with the investment company under audit (Fund C) and therefore qualifies as an affiliate under the investment company complex.

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." 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. If a fund audit is subject to SEC independence rules, the auditor cannot provide any prohibited services to the portfolio companies that roll up into that fund's financial statements.

This rule applies whether the portfolio companies are reported at fair value or are consolidated. It should be noted, however, that this “not subject to audit" exception can be applied to upstream and brother/sister entities of a portfolio company audit client, provided the results of the services would not be subject to audit.

The “not subject to audit” exception **can** be applied to the following otherwise 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
- Legal services
- Expert services, such as litigation support
- Broker-dealer/investment adviser/investment banking/investment advisory services

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 private equity fund management regarding matters such as non-audit services. It is equally important that there be effective two-way communication between private equity fund management and its portfolio companies 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.

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