The Dodd-Frank Wall Street Reform and Consumer Protection Act requires most advisers of private funds to register with the SEC as investment advisers and to comply with the Investment Advisers Act of 1940. The registration requirement generally applies to managers 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 group (PEG) limited partnership or a manager of a limited liability company is likely deemed to have custody of assets maintained in a PEG 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 U.S. Securities and Exchange Commission (SEC) requires registered advisers to maintain certain safeguards to maintain all securities at a qualified custodian. One of the safeguards required under the Act 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, and
- 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 PEG 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. It therefore is important that the registered investment adviser, PEG 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. McGladrey 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 McGladrey and the other RSM International member firms as if we are one entity.

Defining the audit client
When the audited PEG fund is a registrant or has a registered investment adviser, the SEC auditor independence rules apply both to the audit client and its affiliates. 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 audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client's parents and subsidiaries;
- 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; and
- Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

When applying this definition, the following should be noted:

- Control is presumed if there is more than 50% ownership interest. Control also may exist when there is less than 50% ownership interest if there other conditions through which control could be exercised, e.g., board rights, veto rights, a contract, etc.
- Significant influence is presumed if there is more than 20% ownership interest but less than 50% ownership interest or if board rights or similar features are greater than 20% but less than 50%.
- An investment is deemed material if the investment in the investee is 5% or more of the private equity group’s total assets or fund that is subject to SEC rules. 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 impacts not only the services auditors are allowed to provide to the fund client but also the services they are allowed to provide to all portfolio companies controlled by the fund and all other private equity funds under common control and portfolio companies under their control. As illustrated below, 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) This entity has control over the audit client.
(b) This entity is under common control with the audit client.
(c) This entity is one over which the audit client has control.
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; or
- 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 outsourcing 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 brother/sister entities of a portfolio company that is considering an initial public offering.

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 outsourcing services

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

- Internal audit outsourcing services
- Management or human resources functions, e.g. executive searches
- Loaned staffing arrangements
- Litigation support

**Conclusion**

Maintaining auditor independence in a private equity environment can be particularly challenging given the significant number of entities under common control. It therefore is important that there be effective two-way communication between the auditor and PEG fund management regarding matters such as non-audit services. It is equally important that there be effective two-way communication between PEG fund management and its portfolio companies regarding these matters. Please contact your McGladrey audit engagement partner for answers to questions regarding the application of SEC auditor independence rules to your specific situation.
800.274.3978
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