

## Effect of Non-Audit Services Provided to Newly Registered Investment Advisers on Auditor Independence

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Historically, auditors may have prepared the audited financial statements for many of their hedge fund audit clients. This has typically been due to the fact that investment advisers of hedge funds do not have a large infrastructure and often did not have the internal resources or expertise to prepare financial statements in accordance with accounting principles generally accepted in the U.S. In addition, auditors are not prohibited under the American Institute of Certified Public Accountants (AICPA) independence standards from performing these services. In February 2006, investment advisers with greater than 15 clients and/or more than \$25 million in assets under management were generally required to register as an investment adviser with the Securities and Exchange Commission (SEC). On June 23, 2006, the U.S. Court of Appeals issued a decision vacating this rule and, therefore, alleviating some of the registration requirements. Since this did not occur until June 23, 2006, many investment advisers have already registered and have chosen to maintain their registration with the SEC. As such, registered investment advisers and their auditors must adhere to SEC independence standards that are more stringent than AICPA independence standards.

Under SEC independence standards, auditors independence is deemed to be impaired if non-audit services are provided to the registered investment adviser by the auditor. One example of non-audit services prohibited under SEC independence rules are bookkeeping services. Bookkeeping services are defined by the SEC as including: (i) maintaining or preparing the registered investment advisers, and/or its sponsored hedge funds, accounting records; (ii) preparing the financial statements for the registered investment adviser and/or its sponsored hedge funds; or (iii) preparing or originating source data underlying the registered investment adviser and/or its sponsored hedge funds financial statements. As such, newly registered investment advisers, as well as previously registered investment advisers, would no longer be able to allow their auditors, or the auditors of their sponsored hedge

funds, to prepare financial statements as part of their audit services, regardless of the registered investment adviser's resource constraints.

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If the newly registered investment adviser has not implemented sound internal controls over financial reporting, the newly registered investment adviser should begin the process to develop such internal controls over financial reporting to ensure adherence to the SEC independence standards as the relief provided under the August 28, 2006 SEC letter which expires on June 30, 2007.

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On August 2, 2006, Deloitte & Touche LLP filed a letter with the SEC requesting temporary no-action relief from the Advisor Custody Rule for certain hedge fund advisers. Such a letter was sent to the SEC in order to seek relief from the burden put on newly registered investment advisers in connection with preparing financial statements for their sponsored hedge funds in accordance with accounting principles generally accepted in the U.S. This letter asked the SEC to continue to allow the auditor to perform non-audit services allowed under AICPA standards until June 30, 2007, without the SEC seeking enforcement action against the newly registered investment adviser or their auditor.

The SEC responded to the Deloitte & Touche LLP letter on August 28, 2006. The SEC agreed that they would not recommend enforcement action to any newly registered investment adviser or their auditor if the auditor was performing non-audit services prohibited under the SEC independence standards, as long as such services were to cease by June 30, 2007. A newly registered investment adviser is defined as those

investment advisers that were not registered with the SEC prior to January 1, 2005, but were required to register in February 2006 under the rule that was vacated on June 23, 2006.

Additionally, the SEC required that the registered investment adviser disclose in the footnotes to the registered investment adviser and/or its sponsored hedge funds' financial statements the following – if the non-audit services described above were provided up to June 30, 2007:

- The auditor was independent under AICPA independence standards;
- The auditor was not independent under the SEC independence standards;
- The general reason why the auditor was not independent under the SEC standards;
- A brief description of the relief and the duration of the relief of the SEC independence standards granted by the SEC.

As such, newly registered investment advisers may continue to have the registered investment adviser's, as well as its sponsored hedge fund's, financial statements prepared by their auditors for the year ending December 31, 2006. However, the newly registered investment adviser will be required to disclose the aforementioned items if the newly registered invest-

ment adviser decides to continue to have their auditor prepare financial statements in accordance with accounting principles generally accepted in the U.S. Investment advisers that are not deemed "newly" registered investment advisers are not subject to any relief, and the registered investment adviser, as well as their auditors, must continue to adhere to the SEC independence standards. It is encouraged that all registered investment advisers speak to their auditors about the implication of the SEC independence standards and how such independence standards will impact the registered investment adviser's and/or its sponsored hedge funds' audits for the year ending December 31, 2006. In addition, if the newly registered investment adviser has not implemented sound internal controls over financial reporting, the newly registered investment adviser should begin the process to develop such internal controls over financial reporting to ensure adherence to the SEC independence standards as the relief provided under the August 28, 2006 SEC letter which expires on June 30, 2007. ©