Surprise! What You May Not Know About Recent Changes to the Professional Standards for Accountants Governing Surprise Examination Engagements under the Custody Rule

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Amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940, the Custody Rule, adopted in 2010, were designed to provide expanded safeguards for clients of investment advisers. Among these amendments to the Custody Rule is a provision that requires advisers to undergo annual surprise examinations when they are deemed to have custody of client funds or securities.

Despite many years of implementation, the amendments, including the surprise exam requirement, continue to raise questions and cause confusion for investment advisers. Advisers also may not be aware of recent changes to the professional standards for accountants governing surprise examination engagements as a result of the American Institute of Certified Public Accountants' ("AICPA") adoption of Statement on Standards for Attestation Engagements No. 18 ("SSAE 18").

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Is Your Accounting Firm Both Registered With, and Subject To Regular Inspection By, The Public Company Accounting Oversight Board? In Certain Situations, That's the Question.

The Custody Rule provision that requires annual surprise examinations states that they must be conducted by an independent public accountant. If the adviser or a related party of the adviser is maintaining client assets as a qualified custodian, the independent public accountant must be both registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB"). When the adviser or a related person is acting as a qualified custodian, the adviser also must undergo an internal control examination, which must be conducted by an independent public accountant both registered with, and subject to regular examination by, the PCAOB.

Additionally, the 2010 amendments to the Custody Rule allowed for an exception from the surprise examination requirement for advisers to pooled investment vehicles, as long as the pooled investment vehicle is audited by an independent public accountant both registered with, and subject to regular inspection by, the PCAOB. The adviser also is required to distribute the audited financial statements of the pooled investment vehicle to its investors. Advisers to pooled investment vehicles relying on the audit exception to satisfy the Custody Rule must use an auditor regularly receiving PCAOB inspections. The sphere of accounting firms offering audit services for private funds is vast, but not all of those firms are regularly inspected by the PCAOB.

With this reasonable and prudent requirement for advisers in these particular situations, the SEC rightly concludes that firms registered with and regularly inspected by the PCAOB focus more substantially on audit quality than firms not subject to the rigor of regular PCAOB review.

PCAOB auditing standards are more stringent than Generally Accepted Auditing Standards. For example:

- The standards require a second partner, referred to as the engagement quality reviewer, to perform a quality review of the working papers and financial statements.
- There are enhanced independence requirements aimed at ensuring the independence and objectivity of the audit team.
- More rigorous audit documentation standards lead to more thorough, complete, and timely secured working papers for each audit engagement.

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PCAOB registered and inspected firms must implement policies and procedures to comply with these standards, and firms generally adopt policies on a firm-wide basis. It is reasonable to expect, as the SEC has concluded, that these polices are followed for all engagements, not just engagements performed for public issuers.

While the comment period for these Custody Rule amendments produced a fair amount of agreement with this requirement, it also was met with some dissent. Commenters argued that PCAOB inspections cover audits of public issuers only, which would not include a surprise examination required by Rule 206(4)-2. Others noted the relative paucity of auditors registered with and regularly inspected by the PCAOB in some locations, particularly in certain foreign jurisdictions. Nevertheless, the SEC upheld the requirement in the final rule, citing their belief that PCAOB inspection confers benefits to a firm's engagements beyond public company audits, and that this focus on quality supersedes the noted concerns.

Despite the clarity in the language detailing this requirement, this aspect of the rule appears to have caused confusion among some advisers and accounting firms. To comply with Rule 206(4)-2, the independent public accountant conducting the surprise examination, internal control examination, or audit of a pooled investment vehicle, in the scenarios detailed above, must be *both* registered with, and subject to regular inspection by, the PCAOB. The words "both" and "regular" are the issue. If an accounting firm is registered with the PCAOB, but not subject to regular inspection, then the firm is not eligible to conduct these particular engagements, as the requirement is currently detailed in the Rule.

What does it mean to be both registered with, and regularly inspected by, the PCAOB? An independent public accountant must have provided audit services for at least one public issuer during any of the last three prior calendar years to be both registered with, and regularly inspected by, the PCAOB. Accounting firms with less than 100 issuer clients are inspected every three years, and firms with 100 or more issuer clients undergo annual inspections. Any accounting firm can register with the PCAOB, but without issuer clients, there will be no inspection. Thus, independent public accountants not subject to regular PCAOB inspection will not meet the surprise exam requirements of Rule 206(4)-2, again in the scenarios detailed above.

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Additionally, we believe that independent public accountants that are inspected by the PCAOB only because they provide audit services for securities broker-dealers will not satisfy the requirements of Rule 206(4)-2 in the situations described above. While broker-dealer audits are currently under the purview of the PCAOB, broker-dealers are not issuers. Examinations of broker-dealer audits are conducted separately from regular PCAOB inspection, and examination reports for broker-dealer audits are not part of regular inspection reports, nor are they publicly available. While the PCAOB is currently contemplating moving to a regular inspection process for broker-dealers, that movement has not yet happened. The public availability of inspection reports is important evidence in determining an accounting firm's commitment to audit quality. With no data to support the assertion of audit quality, the knowledge that an accounting firm conducts audits of broker-dealers would not necessarily confer the same confidence one would have in an auditor of public issuers with readily available, regular inspection reports.

Bottom Line: If required to undergo a surprise examination under Rule 206(4)-2, and you or a related party is acting as qualified custodian, or if in compliance with the Rule due to the pooled investment vehicle audit exception, advisers should review their current provider carefully and ask the following questions:

- ***Does the independent public accountant currently audit issuer clients?***
- ***How many issuers does the firm audit?***
- ***Is the firm regularly inspected by the PCAOB? When was the firm's last PCAOB inspection?***
- ***What were the results of the inspection?***

SSAE 18 Now Requires a Deeper Dive Into the Risk of Material Noncompliance

Surprise examination engagements performed pursuant to the Custody Rule are considered compliance examination engagements performed in accordance with the professional attestation standards established by the AICPA. These standards govern a wide variety of engagements in which an independent public accountant "attests" on a subject matter based upon certain criteria. Through these types of engagements, the independent public accountant can report either directly on an adviser's compliance with, or on an adviser's assertion of compliance with, both paragraph (a)(1) of Rule 206(4)-2(a) and Rule 204-2(b).

In order to be able to report on compliance with the Custody Rule, the accounting firm generally must verify that client funds deemed to be under custody of the adviser are held by a qualified custodian in a separate account for each client (paragraph (a)(1) of Rule 206(4)-2) as of the surprise examination date and that the adviser maintained the necessary books and records during the

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examination period (Rule 204-2(b)).

The books and records required to be maintained for each client account under custody in accordance with Rule 204-2(b) includes, among other requirements, that a separate journal or other record be maintained showing all purchases, sales, receipts, and deliveries of securities as well as all other debits and credits to such accounts. However, Rule 204-2(h) indicates that records maintained by a broker-dealer in compliance with Rule 17a-3 and 17a-4 under the Securities Exchange Act of 1934 can be deemed to satisfy the requirements of Rule 204-2(b), provided that they are substantially the same types of records as required by Rule 204-2(b). Accordingly, advisers should consider the cost and benefits of maintaining books and records separate from that of the qualified custodian as well as whether the custodian's records satisfy the adviser's compliance requirements of Rule 204-2(b).

During the course of a surprise examination engagement, the independent public accountant will typically confirm the existence of each of the adviser's client's assets directly with the qualified custodian holding such assets. In addition, the accountant will confirm, directly with the adviser's clients, the cash and security positions held as of the examination date as well as the activity within each account during the examination period (the date of the prior examination date through the current examination date). These procedures can be performed for either all or a sample of client accounts under custody based upon the judgement of the accountant. While these are generally the two primary procedures performed by the accountant, the professional attestation standards require certain additional procedures for all examination engagements. Such procedures were recently expanded with the adoption of the Statement on Standards for Attestation Engagements No. 18 ("SSAE 18") by the AICPA. These standards became effective for all attestation engagement reports issued by an accountant on or after May 1, 2017.

Among other changes, the adoption of SSAE 18 expanded the accountant's requirement to perform certain risk assessment procedures in order to determine the risk of "material misstatement" or, in the case of a compliance examination engagement, the risk of "material noncompliance." With respect to surprise examination engagements performed pursuant to Rule 206(4)-2(a), the accountant should perform inquiries of management regarding their operations to determine if there is a heightened risk of material noncompliance with the provisions of the Custody Rule that the accountant is reporting upon. Such inquiries may include, but are not limited to, how an adviser determined which accounts were deemed to be under custody as well as how the adviser records and reconciles its books and records with the custodian's books and records. While such inquiries may result in the adviser modifying its list of client accounts within the scope of the examination engagement, it is ultimately the adviser's responsibility to determine which accounts are deemed to be under custody, and the accountant's report will include certain language indicating as such.

Bottom Line: Advisers can expect additional inquiries from their provider as a result of the adoption of SSAE 18, but the most significant aspects of the engagement will still revolve around direct confirmation by the independent public accountant with the adviser's clients and custodians.

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UPCOMING COMPLIANCE DATES

The following selected compliance dates are listed as a reminder for IAA Newsletter readers. For questions or more information, please contact the IAA legal staff.

August 14: Institutional investment managers that exercise investment discretion over $100 million or more in Section 13(f) securities must ***file Form 13F*** (45 days after the quarter ended June 30).

August 14: NFA-member CTAs must ***file NFA Form PR*** for the quarter ended June 30.

August 29: Large hedge fund advisers (with at least $1.5 billion RAUM attributable to hedge funds) must ***file Form PF*** for the quarter ended June 30.*

August 29: Large CPOs must ***file Form CPO-PQR*** for the quarter ended June 30.

August 29: NFA-member CPOs must ***file NFA Form PQR*** (or file CFTC Form CPO-PQR if a "large filer") for the quarter ended June 30.

**This deadline applies to advisers with a December 31 fiscal year-end.*