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Understanding Audits & Fund Administration under the Reform & Integrity Act

The EB-5 Program has an over 32-year history during which it has generated billions of dollars in foreign investment, created hundreds of thousands of jobs and has drawn much needed capital and vital improvements to communities in need. Unfortunately, the program remains controversial, due in large part to bad actors, bad publicity, program abuses and cases of fraud.

The introduction of the EB-5 Reform and Integrity Act of 2022 (the “RIA”), supported by IIUSA, is intended to reduce the risk of fraud and other abuses. This law has numerous requirements, restrictions, and additional supervisory responsibilities for regional centers. One of the new requirements in the RIA is that New Commercial Enterprises (NCEs) are now required to use an independent-fund administrator to provide oversight and track the disbursement of EB-5 capital, and thereby

improve transparency, security, and reporting compliance. NCEs may obtain a waiver from the fund administrator requirement if the financial statements of the NCE and affiliated job creating entity (“JCE”) are audited by an independent accounting firm.

While using independent fund administrators, and independent auditors should help improve EB-5 Program integrity, these two options are very different processes. The purpose of this article is to shed some light on the differences, the benefits, and advantages of each.

[An Overview of Fund Administration](#)

Broadly speaking fund administration is the execution of all the “back-office” functions necessary to support an investment fund. These functions include fund accounting, financial reporting, investor on-boarding and communications, capital calls, distributions, monitoring investment compliance, and

Continued On Page 29



Continued From Page 27

so on. Fund administrators are a critical intermediary between fund managers and investors.

Independent companies specializing in fund administration began to appear as an industry group after the 1997 Taxpayer Relief Act. Initially the growth in the use of independent fund administrators was driven by fund managers that benefited from the expertise and efficiencies of the fund administrator. Outsourcing the back-office administration provided cost benefits and also allowed fund managers to focus on their core business. However, the financial crisis in 2008, including the Madoff scandal discovered in 2008, highlighted the risks of fraud when independent fund administration was not used. Prior to 2008, less than 10% of hedge fund managers used independent fund administrators, after 2008, this percentage increased to 90%.¹

Sophisticated investors understand that an independent fund administrator is closely involved with the regular activity of the fund. The fund administrator improves transparency, security and compliance and dramatically reduces the potential for fraud since any discrepancies in money movement, account balances, investor on-boarding, or financial statements are identified and resolved immediately.

Fund administration in EB-5 involves monitoring, tracking, and recording of investor money in segregated accounts.

¹ Private Equity Legal & Compliance Digest <https://www.centaurfs.com/wp-content/uploads/2017/08/PE-Firms-Increasingly-Turn-to-Administrators-as-Regulatory-and-Investor-....pdf>

The monitoring and tracking begin with the deposit of the funds into a subscription escrow account. This is the beginning of the audit trail that every EB-5 investor will need for a successful I-829 petition to remove conditions on their visa. The fund administrator continues this oversight and tracking from release of capital to the NCE

separate account and then to the JCE for use in the job creating project. During the investment period, the fund administrator continues to track supporting evidence demonstrating that the investor's funds remain at risk until the end of the investor's conditional residency period. As capital is returned to the NCE by the JCE, the fund administrator tracks the return of capital to the investor.

The fund administrator will ensure that all disbursements are appropriate and in accordance with all applicable NCE and JCE agreements, will approve all transfers of funds from the NCE to the JCE and serve as a cosignatory on the accounts for those transfers.

Examples of fund administration and cosignatory requirements include, but are not limited to, the following:

- Approve/Cosign transfers with a written or electronic signature
 - Upload transfers and supporting documentation to portal
 - 24/7 portal access for project owners, investors, and other interested parties
- Capital flow reporting of investor's capital over the entire project lifecycle
 - Document storage for job creating enterprise expenses
 - Monthly statements for each stage: subscription, investment, and settlement
 - Storage for relevant documents
 - Entity formation and operating agreement storage
 - Evidence of fund movement, and funding confirmation letters
 - Verification that requests for transfers are compliant with control policies

Another critical component of the RIA is communication, security, and investor transparency. The independent fund administrator will provide notification to EB-5 investors of the status of their capital as well as a full audit report of the movement of their capital. The document portal provided by the fund administrator will also provide project sponsors and USCIS access to the documents retained on the portal during the entire lifecycle of the NCE.

An Overview of Financial Statement Audits

A financial statement audit is a thorough examination of a company's financial records by independent auditors to ensure the financial statements (generally, income statement, balance sheet, changes in stockholder equity, and cash flow statement) are a fair representation of the company's financial performance during a set time period, usually a calendar or fiscal year. Audits are performed by Certified Public Accounting (CPA) firms in accordance with Generally Accepted Auditing Standards (GAAS) set by The Auditing Standards Board, a subset of the American Institute of Certified Public Accountants (AICPA). Publicly traded companies are required by law to be audited annually by an audit firm registered with the Public Company Accounting Oversight Board (PCAOB). While there is no federal law requiring privately held companies to be audited, many undergo audits due to debt covenants with banks, requirements from investors or shareholders, or various compliance requirements.

During an audit engagement, most of the audit procedures are aimed at detecting and correcting *material* errors. Materiality, in this context, refers to a benchmark used to evaluate misstatement or errors in financial reporting. The magnitude of a material error is such that it might affect the judgment and decision-making of the financial statement

Continued On Page 30

Continued From Page 29

readers. The audit procedures are designed to capture and review transactions that are at or above the designated materiality level. Hence, the scope of an audit is limited. Additionally, sampling is widely used in an audit for selecting and reviewing transactions, which leads to a possibility that a fraudulent transaction will not be selected in the auditors' sample and, therefore, will go undiscovered, especially if it falls below the materiality threshold. Therefore, an independent audit may not identify all incidents of fraud.

Generally, audit engagements are performed in three phases: planning, fieldwork, and reporting. During the planning phase, auditors gain an understanding of the industry and the environment in which the company operates as well as perform walk-throughs of the internal controls in place to identify and assess the risk of material misstatement. Based on the findings in the planning stage, a detailed audit plan is developed which entails determining the nature, timing, and extent of testing to be conducted during fieldwork. During the fieldwork stage, auditors select samples of transactions for testing, gather and corroborate information, trace amounts to underlying supporting documents, and seek third party confirmation for certain material items, such as revenue or accounts receivable. Upon evaluating the results of the testing performed, the auditors determine whether the financial statements of the company present fairly the financial results and financial position of the company as of the date of the financial statements, and report their findings in the form of an audit opinion.

Upon completion of the audit, an audit opinion is issued and will fall in one of four categories. An *unqualified opinion* (often

called a "clean" opinion) indicates that the financial reports are fair and accurate and free of material misstatement. A *qualified opinion* indicates that the financial statements are presented fairly with specific exceptions that are further outlined in the audit report. An *adverse opinion* indicates that the auditors found material misstatements in the company's financial records due to fraud or error and often indicates a serious lack in internal controls. The fourth and last audit opinion is a *disclaimer opinion* which is not an actual opinion, but a declaration that an opinion could not be assessed due to lack of cooperation from management or inadequate financial records.

How to Choose which Method to Use for EB-5

Fund administration and financial statements audits are two very different methods of mitigating the risk of fraud. It is perhaps hard to understand why the RIA presented a choice of one or the other, as they each have unique roles and benefits for Regional Centers, NCEs, JCEs and ultimately, investors.

As described above, fund administration is a very comprehensive tool that is integrated into an EB-5 fund's transaction infrastructure before the fund-raising process begins, then through a variety of complementary tracking, control, administrative and approval mechanisms, it provides a roadmap of checks and balances throughout the entire duration of an EB-5 offering. This holds all of the EB-5 entities involved in a transaction accountable, which is especially important for offerings that may have common ownership, and therefore conflicts of interest, among the various Regional Center, developer, NCE and JCE entities. Having this third-party oversight is designed to provide comfort and transparency to the investor, which is a crucial element in creating an environment of trust that the flow of funds is occurring as intended, and that the investor's capital investment is being protected before, during and after the transaction has been consummated.

While fund administration is arguably a preventative tool, a financial statements audit is mainly an evaluative and reporting tool that analyzes financial transactions after they have occurred. An audit is also an extremely important instrument to examine whether the financial results that are reported by a



transaction or entity are a fair representation of what actually did happen. As noted above, financial audits are guided by regulatory organizations with procedures, guidance and testing methods that accounting firms have utilized for decades. Getting an unqualified audit opinion provides assurance to investors that there is a higher degree of review and support for a company's financial statements. However, a full financial audit can be expensive, and may require additional time and effort for the NCE and JCE to prepare for the audit.

Among hedge funds and private equity funds, the common practice is to use both fund administration and financial statement audits. Using both does not entirely eliminate the risk of fraud or losses, but these controls do deter some fraudulent conduct and can detect fraud more readily when it does occur.

When due diligence firms and broker-dealers examine an EB-5 offering to determine the strengths and weaknesses of the offering, the presence of both a third-party fund administrator AND an independent auditor provides a much stronger comfort level than if only one of the tools have been implemented.

If the EB-5 industry as a whole desires to increase the integrity and reputation of EB-5 financing in the U.S. capital markets (and the media), there is a strong argument for choosing both independent fund administration and financial statements audits. While utilizing both will increase the costs of EB-5 offerings, the combined benefits of both will not only strengthen the ultimate outcome and integrity of EB-5 transactions, but it will also strengthen the perception of the EB-5 industry in the long run. ▶

