



# EXPOSURE DRAFT

## Proposed Interpretation

State and Local Government Client Affiliates (*formerly*  
Entities Included in State and Local Government  
Financial Statements)

**AICPA Professional Ethics Division**  
**January 11, 2019**

**Comments are requested by March 11, 2019**

Prepared by the AICPA Professional Ethics Executive Committee for comments from those interested in independence, behavioral, and technical standards matters. Comments should be addressed to the Professional Ethics Division, Ethics-ExposureDraft@aicpa-cima.com

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January 11, 2019

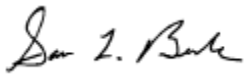
This exposure draft contains an important proposal for review and comment by the AICPA's membership and other interested parties regarding a pronouncement for possible adoption by the Professional Ethics Executive Committee (PEEC). The text and an explanation of the proposed pronouncement are included in this exposure draft.

After the exposure period is concluded and PEEC has evaluated the comments, PEEC may decide to publish the proposed pronouncement. Once published, the pronouncement will become effective on the last day of the month in which it is published in the *Journal of Accountancy*, unless otherwise stated in the pronouncement.

Your comments are an important part of the standard-setting process; please take this opportunity to comment. Responses must be received at the AICPA by March 11, 2019. All written replies to this exposure draft will become part of the public record of the AICPA and will be available at [www.aicpa.org/interestareas/professionalethics/community/exposuredrafts.html](http://www.aicpa.org/interestareas/professionalethics/community/exposuredrafts.html). PEEC will consider comments at its subsequent meetings.

Please email comments to the Professional Ethics Division (Ethics-ExposureDraft@aicpa-cima.com).

Sincerely,



Samuel L. Burke, Chair  
AICPA Professional Ethics Executive Committee



Toni Lee-Andrews, Director, CPA, PFS, CGMA  
Professional Ethics Division

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# Contents

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	<b>Page</b>
<b>Explanation of the Proposed Revisions .....</b>	<b>6</b>
<b>Text of Proposed Interpretation “State and Local Government Client Affiliates” .....</b>	<b>8</b>

## Explanation of the Proposed Revisions

On July 7, 2017, the Professional Ethics Executive Committee (PEEC) exposed for comment revisions to the interpretation “State and Local Government Entities” (ET sec. 1.224.020). These revisions are referred to in this explanation as the *initial exposure draft*. Based upon feedback received and further discussion of the issues, PEEC made a number of changes to the initial exposure draft. As such, PEEC is issuing this new exposure draft (second exposure draft) and seeks feedback on only the changes from the initial exposure draft.

### **Substantive Revisions Proposed**

PEEC believes the following three revisions represent substantive changes to what was proposed in the initial exposure draft.

First, the extant interpretation is silent about when members should consult the “Conceptual Framework for Independence” when they have relationships or circumstances with entities other than those specified in the interpretation. Accordingly, the initial exposure draft included paragraphs .09 and .10 to outline a member’s requirements in such situations. Paragraph .09 in the initial exposure draft required members to evaluate, using the “[Conceptual Framework for Independence](#)” (ET sec. 1.210.010), relationships and circumstances they have with certain upstream entities of a financial statement attest client. Some commenters believed that the cost of complying with this new requirement in paragraph .09 for certain upstream entities outweighed the benefits derived. To address this concern, this second exposure draft replaces the requirement with examples of relationships or circumstances that members may have with upstream entities (as well as other entities now referred to as *nonaffiliates*) that could result in the member consulting the “Conceptual Framework for Independence.” These examples are reflected in paragraph .06 of this second exposure draft.

Second, paragraph .13 in the initial exposure draft indicated that members should expend best efforts to obtain the information necessary to identify investments held by a financial statement attest client. Upon further reflection, PEEC now believes this provision should be available to all affiliates, which would be consistent with the “Client Affiliates” interpretation (ET sec. 1.224.010). This revision is reflected in paragraph .08 of this second exposure draft.

Third, paragraph .14 of the initial exposure draft requires that members should presume that the financial statement attest client can exercise more than minimal influence over an entity when determining if an entity is an affiliate. PEEC believes that this presumption will be rebutted less frequently when funds and blended component units are being evaluated but more frequently when a discretely presented component unit is being evaluated. Accordingly, PEEC is proposing in this second exposure draft that members presume only that the financial statement attest client has more than minimal influence over funds and blended component units. For discretely presented component units, members will need to evaluate on a case-by-case basis.

### **Clarifications**

PEEC is proposing a number of clarifications to the initial exposure draft. PEEC believes these clarifications do not change the substance of the requirements in the initial exposure draft; rather, they will assist members with operationalizing the requirements. The significant clarifications are as follows:

- Replacement of the term *primary government* to *affiliate* and *entity* because the definition used in the first exposure draft for primary government differed from the GASB definition.
- A clarification has been added, noting that members do not need to evaluate investments of all downstream affiliates; rather, they need to evaluate only investments of (1) the financial statement attest client and (2) any entity that is included in the financial statement attest client’s financial statements when the member does not make reference to another auditor’s report on the entity when determining whether the investment is an affiliate.
- Additional explanatory guidance regarding how to determine materiality.
- Replacement of the term *de minimis* to *trivial* and *clearly inconsequential*. This clarification was made in response to feedback received on the first exposure draft that it was not clear how to value whether an

investment was *de minimis*. Because the terms *trivial* and *clearly inconsequential* are discussed in AU-C section 450, *Evaluation of Misstatements Identified During the Audit*,<sup>1</sup> PEEC believes members will understand how to apply these terms better than the term *de minimis*.

### ***Request for Specific Comments***

PEEC is seeking feedback on the following specific aspects of the proposed interpretation:

1. Are the examples of circumstances or relationships with nonaffiliates that could result in the member consulting the “[Conceptual Framework for Independence](#)” helpful to assessing when the conceptual framework may be applicable? If not, please provide other suggested examples or circumstances that should be included.
2. Does this exposure draft provide clear guidance to the member on how to determine which entities are affiliates to the financial statement attest client? If not, please explain what areas in this exposure draft are unclear.
3. Is it clear that investments will only be considered an affiliate if they are held by the financial statement attest client or by an affiliate under item *a.i.* of paragraph .03? If not, please provide a suggested clarification on how to make it clear that investments of these two entities only will be considered an affiliate.
4. What implementation guidance do you believe would be helpful for the Ethics Division to develop so that the interpretation can be successfully implemented?

### ***Effective Date***

PEEC believes that members who practice in the state and local government environment will need significant time to implement the proposed revisions. As such, PEEC recommends that the interpretation be effective one year after adoption, with early implementation allowed.

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<sup>1</sup> All AU-C sections can be found in AICPA *Professional Standards*.

## Text of Proposed Interpretation “State and Local Government Entities”

(Formerly “Entities Included in State and Local Government Financial Statements;” revisions to this title appear in strikethrough.)

### ***1.224 Affiliates, Including State and Local Government Affiliates Governmental Units***

#### ***1.224.020 ~~Entities Included in State and Local Government Client Affiliates Financial Statements~~***

##### ***Applicability***

- .01 This interpretation applies to state and local government entities (as defined in item *d.* of paragraph .03 of this interpretation) that are [financial statement attest clients](#).
- .02 When an [interpretation](#) of the “[Independence Rule](#)” (ET sec. 1.200.001) is applied in a state or local government environment and the *interpretation* uses terminology that is not applicable in this environment, the [member](#) should use professional judgement to determine if there is an equivalent term. For example, certain *interpretations* use the phrase “officer, director, or owner of the [attest client](#).” In some state or local government environments, it may be necessary for the *member* to extend these *interpretations* to officials of the [financial statement attest client](#) when the individual has governance responsibilities or control over financial reporting.

##### ***Terminology***

- .03 The following terms are defined here solely for use with this interpretation:
  - a. An affiliate of a state or local government [financial statement attest client](#) exists in all of the following situations.
    - i. The entity is included in the *financial statement attest client’s financial statements*, and the [member](#) or *member’s firm* does not make reference to another auditor’s report on the entity.
    - ii. The entity is included in the *financial statement attest client’s financial statements*, and the *member* or *member’s firm* makes reference to another auditor’s report on the entity, and
      - 1. the entity is material to the *financial statement attest client’s financial statements* as a whole, and
      - 2. the *financial statement attest client* has more than minimal influence over the accounting or financial reporting process over the entity. There is a rebuttable presumption that the *financial statement attest client* has more than minimal influence over the accounting or financial reporting process of funds and blended component units.
    - iii. The entity is a material excluded entity, and the *financial statement attest client* has more than minimal influence over the entity’s accounting or financial reporting process. A material excluded entity is an entity that is required under the applicable financial reporting framework to be included in the *financial statements* of the *financial statement attest client* but is, nevertheless, excluded by the *financial statement attest client* and is



material to the *financial statement attest client's financial statements* as a whole. There is a rebuttable presumption that the *financial statement attest client* has more than minimal influence over the accounting or financial reporting process of funds and blended component units.

- iv. The *financial statement attest client* or an affiliate under item *i.* of this definition (investor) has an investment that either
  1. is not trivial and clearly inconsequential to the investor's *financial statements* as a whole and gives the investor *control* over the investment or
  2. is material to the investor's *financial statements* as a whole and gives the investor *significant influence* over the investment.
- b. An entity is intended to be broadly defined and can include funds, component units, departments, agencies, programs, organizational units, fiduciary activities, custodial activities, employee benefit plans, and suborganizational units of the preceding entities.
- c. An investment is a security or other asset that the *financial statement attest client* or an affiliate under item *a.i.* of this paragraph holds primarily for the purpose of income or profit and has a present service capacity based solely on its ability to generate cash or to be sold to generate cash. This includes investments and ownership of an equity interest in common stock accounted for using the equity method of accounting as provided for in GASB Codification Section 150. The following interests are not considered investments for purposes of this interpretation:
  - i. Interests obtained by a *financial statement attest client* or an affiliate under item *a.i.* of this paragraph as a result of an action by a third party, such as through a bequest or a grant, and that the entity does not intend to retain (temporary investments).
  - ii. Equity interests in joint ventures, partnerships, LLCs, or other types of entities in which the intent of the *financial statement attest client* or an affiliate under item *a.i.* of this paragraph is to directly enhance its ability to provide governmental services.
  - iii. Equity interests in component units in which the intent of the *financial statement attest client* or an affiliate under item *a.i.* of this paragraph is to directly enhance its ability to provide governmental service
  - iv. Interests that would otherwise be considered an entity as defined in item *b* of this paragraph.
- d. State and local government entities are entities whose generally accepted accounting principles standard setter is GASB. Examples of state and local government entities include general purpose governments such as states, counties, cities, towns, villages, and special purpose governments that perform limited activities. Examples of special purpose governments include cemetery districts, school districts, universities and colleges, utilities, hospitals or other health care organizations, public airports, public housing authorities, financing authorities, public transportation systems, public employee retirement systems (PERSS), post-employment benefit plans, pension plans, public entity risk pools,

external investment pools, Indian tribes, state tuition programs, and other special districts.

### **Interpretation**

- .04 Financial interests in, and other relationships with, affiliates of a financial statement attest client that is a state or local government entity may create threats to a member's compliance with the "Independence Rule."
- .05 Members should apply the "Independence Rule" and related interpretations applicable to a state or local government financial statement attest client to their affiliates except as provided for in paragraph .07 of this interpretation.
- .06 Members may encounter circumstances or relationships with nonaffiliates that create threats to independence that could result in the *member* consulting the "Conceptual Framework for Independence" (ET sec. 1.210.010). Examples of such circumstances or relationships include the following:
  - a. A covered member's immediate family is in a key position with a nonaffiliate that includes the financial statement attest client in its financial statements, and the nonaffiliate provides accounting staff, shares financial information systems, or establishes internal controls over financial reporting for the *financial statement attest client*.
  - b. The *member* is considering providing financial information system design services to a nonaffiliate in which the same financial information system would also be used by the *financial statement attest client*.
  - c. A *covered member* has a *financial interest* in a nonaffiliate that includes the *financial statement attest client* in its *financial statements*, and the nonaffiliate prepares the *financial statements* for the *financial statement attest client*.
  - d. The *financial statement attest client* participates in a public private partnership or joint venture that does not meet the definition of an *investment* in item c. of paragraph .03 of this interpretation. A *covered member* has a *financial interest* in an organization that is also involved with the public private partnership or joint venture.
  - e. A *covered member* owns utility bonds issued by a nonaffiliate, and the *financial statement attest client* is responsible for payment of the utility bond debt service.
  - f. A *covered member* owns defeased debt issued by the *financial statement attest client*. The defeased debt is not accounted for on the *financial statements* of the *financial statement attest client*, and the *financial statement attest client* has funded the debt service to be paid from a bank trust account.
  - g. A *covered member* owns conduit debt issued by the *financial statement attest client* on behalf of a nonaffiliate. The conduit debt is not accounted for on the *financial statements* of the *financial statement attest client*, and the debt service is paid by the nonaffiliate.

### **Exception**

- .07 The member and *member's firm* may provide prohibited nonattest services to entities described under items *a.ii.* and *a.iii.* of paragraph .03 during the period of the professional engagement or during the period covered by the financial statements, provided that it is reasonable to conclude that the services do not create a self-review threat with respect to the

financial statement attest client because the results of the nonattest services will not be subject to the covered member's financial statement attest procedures. For any other *threats* that are created by the provision of the nonattest services that are not at an acceptable level (in particular, those relating to management participation), the *member* should apply safeguards to eliminate or reduce the *threats* to an acceptable level.

### **Best Efforts**

.08 A member must expend best efforts to obtain the information necessary to identify affiliates of a financial statement attest client. If, after expending best efforts, a *member* is unable to obtain the information to determine which entities are affiliates of a *financial statement attest client*, *threats* would be at an acceptable level and independence would not be impaired if the *member* does all of the following:

- a. Discusses the matter, including the potential impact on independence, with those charged with governance at the *financial statement attest client*
- b. Documents the results of that discussion and the efforts taken to obtain the information
- c. Obtains written assurance from the *financial statement attest client* that it is unable to provide the *member* with the information necessary to identify the affiliates of the *financial statement attest client*

### **More Than Minimal Influence Over Accounting and Financial Reporting Process**

.09 The overall facts and circumstances should be considered when evaluating the level of influence the financial statement attest client has over the accounting or financial reporting process of an entity in the financial reporting entity. The targeted analysis is applied solely to the accounting and financial reporting process of the entity as opposed to the analysis of what entities are included in the financial reporting entity. Factors such as the following may assist members with this evaluation.

- a. The extent of involvement the *financial statement attest client* has in preparing the financial statements of an entity.
- b. The extent of operational control the *financial statement attest client* has over an entity.
- c. The extent to which both the *financial statement attest client* and an entity have the same
  - i. accounting or finance staff
  - ii. accounting systems
  - iii. internal control over financial reporting systems
- d. The extent to which the *financial statement attest client*
  - i. is able to direct the behaviors or actions of the governing board of the entity
  - ii. has the ability to add or remove members of the governing board of the fund or component unit
  - iii. issues or pays for the entity's debt
  - iv. finances the entity's deficits
  - v. uses or takes the entity's financial resources

.10 Whereas some factors may indicate influence, others may indicate little to no influence. Some factors may be weighted differently depending on the circumstances and the subject matter of any potential impairment. Members should take a substantive approach to evaluating the

factors (for example, the entity exercises a right), rather than merely considering form (for example, the *financial statement attest client* has a right that is not exercised). The consideration of these factors will require the *member* to exercise professional judgement when reaching the determination of whether more than minimal influence exists.

***Material to the Financial Statement Attest Client's Financial Statements as a Whole***

.11 Determination of materiality is a matter of professional judgment. [Members](#) should consider both quantitative and qualitative factors when determining whether an entity or investment is material to a [financial statement attest client's](#) financial reporting entity. For purposes of this interpretation, materiality is intended to be applied at the *financial statement attest client's* financial reporting entity as a whole, rather than individual opinion units in circumstances in which there may be more than one opinion unit.