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October 16, 2017

Mr. Samuel L. Burke  
Chair, Professional Ethics Executive Committee  
American Institute of Certified Public Accountants  
New York, NY 10036-8775

Mail to: Ethics-ExposureDraft@aicpa-cima.com

**Re: Proposed Interpretation and other guidance—State and Local Government Entities (*formerly* Entities included in State and Local Government Financial Statements) Exposure Draft**

Dear Mr. Burke:

Deloitte & Touche LLP is pleased to respond to the exposure draft prepared by the Professional Ethics Division of the American Institute of Certified Public Accountants' (the "AICPA") of Proposed Interpretation and other guidance—State and Local Government Entities (*formerly* Entities Included in State and Local Government Financial Statements) (the "Interpretation").

We appreciate the opportunity to comment on the Interpretation and commend the AICPA for its continued efforts to re-examine and improve professional standards and guidance applicable to state and local governments.

We believe it is important to periodically review the standards and guidance to ensure they reflect the current auditing environment and practice issues, and meet the needs of the users.

Our comments and recommendations are further discussed below and in the appendix that follows, which contains our detailed responses to the questions posed in the Interpretation.

**Overall**

We believe the Interpretation attempts to address scenarios related to independence in practice that have long existed but may not have not been fully addressed by the extant interpretation. Financial reporting objectives for the state and local government sector differ from the commercial sector and, therefore, it is critical that professional standards and guidance contemplate the financial reporting structure and are reflective of those objectives. We appreciate the efforts of the AICPA to make the Interpretation conceptually consistent with the Client Affiliates guidance and acknowledge differences as necessary between the commercial sector, and the state and local government sector. However, we believe that edits and clarifications are required to ensure that the proposed changes will be easily understood and consistently applied in practice.

## **Explanation of the Proposed Revision**

The explanation of the proposed revision (the "Explanation"), as well as the exhibits, are provided for additional background on the exposure draft and do not become part of the professional standards once the revision is codified. However, certain information is contained in the Explanation that is key to members' understanding of the Interpretation. Accordingly, we recommend that the AICPA review the Explanation and exhibits for elements that should be incorporated into the Interpretation prior to codification. Specifically, we believe the following items/sections in the Explanation should be incorporated into the Interpretation: "Terminology—Downstream, Upstream and Brother-Sister Entities;" "Materiality Considerations;" the clarification of exclusions of customers, vendors, and grant funds provided to other entities from evaluation, as explained in "Other Funds, Component Units of Activities—Paragraph .10 of the Proposal;" and "Defined Terms."

## **Terminology**

### ***Consistency with GAAP and Professional Standards***

The Interpretation provides definitions for key terms in paragraph .04a that are inconsistent with definitions prescribed by the Governmental Accounting Standards Board (GASB). "Primary government" is defined in GASB Codification Section 2100.112. The Interpretation uses a broader definition of "primary government" than the generally accepted accounting principles ("GAAP") provided by the GASB. In GAAP, there can be only one primary government, while application of the Interpretation may result in the determination of more than one primary government when applying the definition upstream. The Interpretation also uses, but does not define, the term "financial reporting entity," which is defined in the GASB Codification Section 2100.111. "Financial reporting entity" as used in the Interpretation is not consistent with the GASB's definition. Using definitions different from the GASB's definitions of these critical terms can lead to practitioners' misinterpretation and misapplication of the guidance. We recommend that the GASB's definition of these terms be applied and the Interpretation be revised accordingly. See also our comment related to "Upstream Application" for further details.

We note that paragraph .04b defines state and local government entities as those entities whose standard setter is the GASB. Further, in paragraph .04c, the Interpretation explains that a fund or component unit is intended to be broadly defined. However, in practice, component units may be entities whose standard setter is the FASB. We recommend this be acknowledged in the Interpretation, as all component units, regardless of standard setter, must be evaluated using the same process and framework.

The Explanation, Section VI. Defined terms—Investments states that "in addition, the investments definition excludes temporary investments for interests obtained by a financial statement attest client..." "Temporary investments" is not a term that is used by the GASB, and, in fact, it is specifically excluded from definition by the GASB in GASB Statement 62, paragraph 561. We recommend the Explanation be updated for terminology that is applicable to state and local governments, and consistent with GASB standards.

The final sentence of paragraph .02 identifies several examples of financial reporting frameworks and states that they are “defined in the auditing standards.” We suggest that “governmental” be removed in the phrase “governmental generally accepted accounting principles (GAAP),” as “governmental GAAP” is not a defined framework. While AU-C 800.07 defines several frameworks other than GAAP, the modified cash basis is not included, and we therefore suggest this wording be removed from paragraph .02. We suggest that the examples of special purpose frameworks provided include only those reflected in AU-C 800.07.

Paragraph .11 refers to “not de minimis” as a criteria for applying the Independence Rule when evaluating attest client’s controlling investments. The term “de minimis” is no longer included in the AICPA auditing standards and is not part of the existing AICPA Code of Professional Conduct (the “AICPA Code”). We recommend replacing “de minimis” with the updated term “clearly trivial” as defined in AU-C 450.A2.

### **The “Not Subject to Attest Procedures—Exception” (Paragraph .08)**

Paragraph .08 provides that independence impairing nonattest services may be provided to downstream material funds and component units as described in paragraphs .06 and .07 of the proposal, provided that it is reasonable to conclude that the results of the nonattest services will not be subject to financial statement attest procedures. However, the paragraph is silent on the application of this exception to other funds, component units, or activities such as those upstream of the financial statement attest client or brother/sister entities. It seems reasonable to conclude that this exception is available to upstream and other affiliates as described in paragraphs 9, 10, and 11, given that the exception is available to nongovernment upstream and brother/sister affiliates per existing interpretation 1.224.010, *Client Affiliates*; however, this is not explicitly stated in the proposal. We suggest that the AICPA consider including specific guidance on the application of this exception to such affiliates.

### **Upstream Application (Paragraph .09)—Financial statement attest client required to be included in another financial reporting entity**

We are supportive of the application of the Conceptual Framework for Independence (the “Framework”) when evaluating independence of an upstream entity. However, further clarification is required as to how far “upstream” the member is required to evaluate independence. In paragraph .09, the Interpretation indicates that the member should use the Framework to evaluate independence when a material fund or component unit (Entity A) is a financial statement attest client and is required to be included in another financial reporting entity that is not a financial statement attest client (Entity B). There could be scenarios in which Entity A is included in Entity B’s financial statements and Entity B is included in a third entity’s (Entity C) financial statements. One such common example would be a foundation (Entity A) that is part of a state university system (Entity B). The consolidated state university system (Entity B) is then included in the state’s (Entity C) financial statements. The Interpretation should clarify whether the member (auditor of Entity A) is required to evaluate independence relative to both Entity B and Entity C in such situations (i.e., ALL entities in which the financial statements of the attest client are included.)

## **Documentation Considerations and Implementation**

Paragraph .09 indicates that members should use the Framework, while Exhibit B in the exposure draft uses the phrase “actively consider threats when applying the Conceptual Framework...” The Interpretation does not contain explicit documentation requirements. Interpretation 1.210.010.09 of the AICPA Code requires that documentation be prepared when safeguards are applied to eliminate or reduce significant threats to an acceptable level during the course of performing a Framework evaluation. We believe a reference to this section of the AICPA Code should be added to the Interpretation.

Further clarification by referencing the AICPA Code will enhance the member’s understanding of what is required as to both the timing and the level of documentation required when evaluating independence as the auditor of a fund or component unit. Because implementation may be significant and costly and the level of effort may be multiplied depending on the levels of upstream consideration, it is critical that the expectation of documentation be more clearly defined in the Interpretation. Clarification is required to ensure that such changes are properly and consistently implemented by members.

## **Materiality**

Multiple references in the Explanation and Interpretation are made to “funds and component units that are material to the financial reporting entity.” Guidance is provided that materiality should be considered in relation to the financial reporting entity rather than to in relation to the opinion unit. However, further guidance related to what is considered “material” is not specified. Because materiality is a matter of professional judgment, it is possible that the auditor of the financial reporting entity may reach a different determination than the auditor of the component unit or fund. We strongly recommend that the Interpretation encourage upstream and downstream communication between the auditor of the financial reporting entity and the auditor of the component unit or fund, and encourage the auditors to reach a consensus on whether the component unit or fund is material in relation to the financial reporting entity (paragraph .09).

## **More-than-Minimal Influence**

Paragraph .14 states that there is a “*rebuttable presumption that the primary government has more than minimal influence over the accounting or financial reporting of a fund or component unit.*” The paragraph further provides a list of factors that auditors can consider to demonstrate that the primary government has only minimal influence. We believe that providing guidance on factors that demonstrate only minimal influence is helpful to auditors and appropriate to include in the Interpretation. However, we do not agree that a primary government will always have more-than-minimal influence over all funds and component units. While the primary government will generally be considered to have more-than-minimal influence over funds, this may not always be the case for component units. Where component units of the primary government have historically been audited by other auditors, the nature of these entities is often such that they are autonomous in operations and financial reporting, thereby, allowing them to be audited by other auditors.

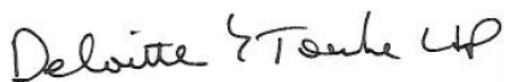
Funds, blended component units, and discretely presented component units have organizational and financial reporting structures that may vary significantly. The member's evaluation of various factors and information is critical in the determination of whether or not the primary government exercises more-than-minimal influence. We believe the professional judgment the member exercises, using knowledge and information gathered related to the fund or component unit and considering the factors provided in the Interpretation, will provide an appropriate foundation for the member to conclude whether the primary government exercises more-than-minimal influence over the fund or component unit. We believe that the Interpretation could offer a decision-tree approach to evaluating more-than-minimal influence or could allow the member to reach and document a conclusion based on facts, circumstances, and factors as listed in paragraph .014. However, we do not believe that the automatic presumption should be that the primary government has more-than-minimal influence over all funds and component units.

For the reasons noted above, we suggest that the language in paragraph .14 be revised to better reflect that various reporting scenarios for funds and component units may occur, and the member should evaluate influence using professional judgment.

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If you have any questions concerning our responses, please contact W. Mike Fritz, Partner, at +1 614 229 4806 or Christopher Cahill, Partner, at +212 436 4841.

Yours truly,

A handwritten signature in cursive script that reads "Deloitte & Touche LLP". The signature is written in dark ink and is positioned above the printed name of the firm.

Deloitte & Touche LLP

## APPENDIX

This revision was made to incorporate the threats and safeguards approach into the “Entities included in State and Local Government Financial Statements” interpretation and incorporate a conceptual framework assessment that can be used to determine when a member needs to be independent of state and local government entities for which he or she is not providing attest services. This revision also clarifies who at the firm and to which immediate family members the Interpretation should extend. In this proposed interpretation, a list of questions was posed to commenters.

We have provided below our detailed responses to the questions posed in the Interpretation.

### Responses to Request for Specific Comments in the Interpretation

1. *Are there any situations in which you believe the framework proposed will not reach the appropriate answer for the general fund? If so, please explain the situation and why you believe the appropriate answer would not be reached.*

We believe the proposed framework will cause the member to reach appropriate conclusions with regard to the general fund.

2. *Paragraph .03 of the proposed revised interpretation notes that 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 their professional judgement to determine if there is an equivalent term and provides an example of one such situation in which PEEC believes this could occur. Are there any other terms or concepts included in the interpretations to the independence rules that PEEC should highlight as an example or consider providing additional application guidance for?*

We note that the Interpretation could provide additional guidance on the information included in ET Section 1.260.020, *Loans and Leases*. In practice, governmental higher education entities are frequently lenders and/or servicers of student loans, certain of which are federally guaranteed. As these circumstances are unique to the state and local government environment, additional application to ensure members’ consistent treatment may be helpful.

3. *Are the entities that would be included in the proposed definition of a primary government in paragraph .04a the entities that should be evaluated for independence purposes? If not, what entities should be evaluated for independence purposes, and should the term primary government be used to describe these entities?*

Please refer to our comments related to “Terminology” in the first part of our letter. We believe the definition of “primary government” and “financial reporting entity” should be based on GAAP definitions as set by the GASB.

4. *PEEC believes that the criteria necessary to undertake the "more than minimal influence evaluation" in paragraph .14 is already available to the auditor as a result of other audit procedures. Do you believe that there are circumstances in which this information is not readily available to the auditor? If so, provide examples of circumstances in which a member may have difficulty in performing this evaluation.*

We believe that the criteria for determining whether the primary government exercises more-than-minimal influence is available when using the definition of primary government as provided by the GASB. When using the definition of primary government as provided in this Interpretation, it is possible that more than one primary government exists and the auditor may be required to evaluate the criteria for more-than-minimal influence with respect to more than one primary government. In such situations, it is much more likely that information may not be readily available to the auditor.

An example follows:

A financial statement attest client—a foundation (Entity A) is included in the financial statements of the financial reporting entity's—a state university system (Entity B)—financial statements. Entity B serves as the primary government to Entity A. Entity B's financial statements (which include Entity A's financial statements) are included in the financial statements of the financial reporting entity—a state government (Entity C). Entity C serves as the primary government to both Entity B and Entity A in this scenario.

5. *The "more than minimal influence over the accounting or financial reporting process over that fund or component unit" concept would require an analysis that is intended to be different than the analysis required for determining which entities are in a primary government's financial reporting entity. In the context of the proposed guidance, is that objective clear? If not, how would you better describe the analysis?*

We believe the language that describes the criteria for more-than-minimal influence should describe if there is any overlap between these criteria and GASB Codification Section 2100.124-.125 (component unit considerations)—or clearly state that objectives are different and the auditor may also consider GASB Codification Section 2100.124-.125, but those may be considered in conjunction with this list.

6. *Paragraph .13 provides a "best efforts" provision that addresses those situations in which a member is unable to obtain the information necessary to identify investments held by a financial statement attest client. Are there any other situations in which you believe a best efforts provision would be necessary, either upstream or downstream, because the financial statement attest client may have difficulty identifying all the entities required to be included in the financial reporting entity?*

We did not identify other situations that would warrant the addition of the "best efforts" provision.

However, we believe the Explanation to the Interpretation should be enhanced to provide background on the perceived risks of independence impairment caused by investing activities by state and local governments. The independence risk appears to lie with entities for which investing is a primary function, such as governmental benefit plans, governmental foundations, or other similar entities, as provided in the Explanation to the Interpretation, and not necessarily with general purpose governments—whose investing activities are not their primary business purpose. As such, enforcing this requirement on general purpose governments may be unnecessary.

7. *Is it clear that the interpretation does not apply to an entity that provides grant funds to the financial statement attest client (or vice versa) unless that entity is a fund or component unit that would otherwise be covered by the interpretation? If not, provide examples of situations in which you believe additional guidance is needed.*

We believe this is clear, when applying GAAP (as defined by the GASB) to a financial reporting entity. It is critical to the Interpretation that the definition of “financial reporting entity” and “primary government” be based on GAAP definitions.

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