

October 16, 2017

Professional Ethics Executive Committee
Professional Ethics Division
American Institute of Certified Public Accountants
220 Leigh Farm Road
Durham, NC 27707

Via email: Ethics-ExposureDraft@aicpa-cima.com

RE: July 7, 2017 Exposure Draft – State and Local Government Entities

Dear Professional Ethics Division and Members of the Professional Ethics Executive Committee:

We appreciate the opportunity to comment on the revisions to the AICPA Code of Professional Conduct proposed by the AICPA Professional Ethics Executive Committee (PEEC) as it relates to State and Local Government Entities. We commend the Committee's attempt to bring consistency to the application of independence standards to affiliates or related entities of the auditee, regardless of whether the auditees are private businesses or governmental entities.

We have reviewed the July 7, 2017 *Exposure Draft – Proposed Interpretation and other guidance - State and Local Government Entities (formerly Entities included in State and Local Government Financial Statements)* and believe that the overall purpose for the proposal cannot be avoided, given the current "Client Affiliates" interpretation that is applicable to commercial sector entities. We appreciate the Committee's extensive consideration of the State and Local Government environment in drafting this interpretation. However, there are certain proposed changes that we believe need further consideration, as detailed below, that would make the standard more understandable and easier to implement.

We do not have any specific responses to the questions included in the "Request for Specific Comments" section of the Exposure Draft, but have other overarching comments. All comments are grouped under the related heading and are in paragraph order as presented in the section of the proposed interpretation labeled "*Text of Proposed Interpretation, "State and Local Government Entities."*"

Terminology (Paragraph 4)

The terminology of *component units and funds* can be confusing as the definition in the Exposure Draft differs from the GASB definition. There is also confusion when using the terms *reporting entity* and *primary government* as the meaning of those terms varies in governments with multiple layers of related entities such as states, and here again, the definition of *primary government* in the Exposure Draft differs from GASB's definition. Given that we are concerned with the independence of the opining auditor, we suggest that the term "*reporting entity*," the entity upon which the opinion is issued, be defined first in paragraph 4a to avoid confusion.

We suggest 4a be reworded to:

The financial reporting entity consists of all “*components*” (***See following comment***) that are required to be included in the financial statements based on the applicable financial reporting framework. The financial reporting entity should be viewed from the perspectives of 1) the attest client’s financial statements (that is, downstream), and 2) the financial statements in which the attest client’s financial statements are included (that is, upstream).

The primary government consists of all of the organizations that make up its legal entity. All funds, organizations, institutions, agencies, departments, and offices that are not legally separate are part of the primary government. The primary government does not include legally separate entities that are required to be included in the financial reporting entity as discretely presented component units. The primary government can be viewed from the perspective of 1) the financial statement attest client (that is, downstream), or 2) the financial reporting entity in which the attest client’s financial statements are required to be included (that is, upstream). If the applicable financial reporting entity is not a legally separate entity (for example, a fund of a City), the primary government for purposes of this interpretation should be the primary government of the legally separate entity that includes the component (for example, a City).

We feel the definitions would be more understandable if we referred to “*components*” instead of *component units and funds* and then defined the term “*components*.” This would bring consistency and brevity to the proposed standards. We suggest the following wording to replace paragraph 4c.

Components are intended to be broadly defined and can include, but are not limited to, funds, departments, agencies, programs, component units, employee benefit plans, and other fiduciary and custodial activities.

Independence of Funds and Component Units Required to be Included in the Financial Reporting Entity (Downstream Entities) of the Financial Statement Attest Client (Paragraph 5)

Paragraph 5 refers to “all funds and component units included in the financial reporting entity.” This should clearly state that we are talking about the component units and funds actually included in the financial statements that are opined upon. As worded, it could be perceived to include component units and funds that should be included in the reporting entity based on the financial reporting framework, but are not. Given that we address those entities separately in paragraph 7, making it clearer that they are not included in paragraph 5 would be helpful to the reader.

Independence When the Financial Statement Attest Client is Required to be Included in Another Financial Reporting Entity (Upstream Entity) (Paragraph 9)

There are certain situations where members audit a fund which is part of a component unit of yet a larger entity. For example, consider the situation where a member audits one fund (the fund) that is part of a legally separate entity (entity A), which is audited by a second firm, and this legally separate entity is a discretely presented component unit of a State (entity B). The State is audited by yet a third firm. When considering upstream independence, it is not clear from the proposed interpretation whether the member would need to evaluate independence to entity A or if the member would have to consider the application of paragraph 9 to both entity A and entity B.

Other Funds, Component Units, or Activities (Paragraph 10)

It is clear that other funds and component units (downstream activities) referred to in paragraph 10 relate to entities included, or that should be included, in the reporting entity financial statements that don't meet the definitions of paragraphs 5, 6, and 7. However, the reference to "activities" is unclear. Further clarification or examples should be provided so members can properly identify what "activities" are subject to this provision. Further, additional clarification as to whether this provision applies to both downstream and upstream "activities" should be added. Examples of downstream and upstream activities should also be included as guidance.

Investments (Paragraph 11)

The paragraphs related to investments utilize the term "de minimus" which is not used in any other provision of the Code of Professional Conduct or found within the auditing standards. We suggest another term that is currently used in the professional language, like "clearly inconsequential" or "clearly trivial." Since the term "clearly inconsequential" is used in the definition of de minimis within the Explanation of the Proposed Revisions, it would seem more efficient and effective to simply use that term.

Determination of Whether the Primary Government of the Financial Reporting Entity has More Than Minimal Influence Over Funds or Component Units (Paragraph 14)

The proposed interpretation starts with a rebuttable presumption that the primary government has more than minimal influence over the accounting or financial processes of a component unit or fund. We do not feel this is appropriate, as such, influence will be dependent on the unique facts and circumstances of the management, operations and governance of each auditee and the applicable component units and funds. This presumption is especially inaccurate for those legally separate entities which are audited by another auditor. Usually other auditors are employed for funds and component units due to the autonomy of these entities and their operations and an ability to be separately audited. Therefore, we do not feel that a presumption that more than minimal influence always exists is appropriate.

We suggest that the standard assume a neutral position as it relates to the ability of the primary government to more than minimally influence the accounting and financial reporting of a component unit or fund. The factors as noted in the paragraph can then be evaluated to determine if more than minimal influence does or does not exist for each specific situation.

An alternative to this neutral position would be to only apply a rebuttable presumption that more than minimal influence exists when the component unit or fund is not legally separate from the primary government.

Overarching Comment

Materiality: Within the *Explanation of the Proposed Revisions*, guidance is provided about materiality for both downstream as well as upstream entities. The guidance indicates that when determining whether independence is required of an entity, materiality is to be determined in relation to the financial reporting entity as a whole and not to materiality as determined at the individual opinion unit. This very important and clarifying information that adds much needed context to the proposed interpretation. However, absent it being within the actual standard itself, we believe significant confusion will occur. Therefore, we suggest that this explanation be provided within the text of the interpretation itself.

Correction Needed to Table C

Table C within the Explanation of Proposed Revisions contains a typo. Within the purple box reflecting Entity C, the second bullet point reads: “Investment **not** *de minimis to plan*” (emphasis added). In the text within the grey section directly below, a contrary fact was presented with the sentence, “Firm E does not have to monitor its independence with respect to Entity C (because the investment is *de minimis to the plan*).” We believe the bullet point in the purpose box related to Entity C should be changed to eliminate the word “not” which will ensure consistency between the facts presented in all sections of this example.

We appreciate the opportunity to provide these comments to you and are happy to discuss them with a PEEC representative.

Please contact Michelle Watterworth at michelle.watterworth@plantemoran.com with any questions.

Very truly yours,

Plante & Moran, PLLC

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