



COMMONWEALTH of VIRGINIA

Auditor of Public Accounts

Martha S. Mavredes, CPA
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218
(804) 225-3350

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Mr. Samuel L. Burke
Chair
AICPA Professional Ethics Division
Ethics-ExposureDraft@aicpa-cima.com

To Whom It May Concern,

We appreciate the opportunity to respond to the AICPA Professional Ethics Executive Committee's (PEEC) exposure draft on the *Proposed Interpretation and other Guidance - State and Local Government Entities*. In general, we understand the threats PEEC is attempting to address through the new guidance. However, we have comments for further consideration.

Overall, we believe that the benefit of updating the interpretation does not align with the cost associated with implementation. The exposure draft (page 22) states that it will take the SLG environment members significant time to implement the proposed revisions. We agree with this assessment; however, we are unconvinced that the risks PEEC is addressing are significant in a governmental context or that the new requirements will have any consequential effect on actual or perceived audit quality. We encourage PEEC to analyze the cost of this new guidance against the benefit to ensure the benefit outweighs the cost.

Specifically, we question the benefit in paragraph 06 of requiring members to apply the Independence Rule when making reference to another auditor's report on a material fund or component unit (component). Regardless of whether the primary government has the ability to exercise influence over the accounting or financial reporting process of the component, the component auditor must be independent of the component and is responsible for testing and attesting to the accuracy of the component's accounting and financial reporting. Once the primary government receives the audited financial statements of the component, it may be required to make minor reclassifications to compile and aggregate the audited financial information into the financial statements of the group, but by in large, the audited information does not require significant alteration. While we can theorize a scenario in which independence

may be at least indirectly relevant to a covered member when making reference to another auditor, we do not believe the risk is significant enough to warrant the change in the proposed interpretation.

Additionally, we question the benefit in paragraph 11, related to investments, of requiring members to apply the Independence Rule to entities in which audit clients have controlling interests or significant influence. While the guidance explained at length the logic behind the significance thresholds and considerations over practicality of obtaining necessary information, it did not initially address the risk it is intending to address, that is, specifically how an audit client having a controlling interest in an entity would potentially result in an independence threat to the auditor. We presume that PEEC is attempting to address the self-interest threat when an auditor has a direct financial interest in an entity in which the audit client has a controlling interest or significant influence. While we can theorize a scenario in which independence may be at least indirectly relevant to a covered member invested in an entity described above, perhaps when the poor performance of an investment may cause a governing body to divest itself from it, we believe it would be rare that the reporting of an investment by an audit client would have any effect on the value of the investment to its investors.

We also found the revised language in the interpretation to be incomplete when reviewed as a stand-alone document, as there are concepts and expectations, which are only clear in the explanation guidance. We are unclear on whether the Committee plans to formally codify the "Explanation of the Proposed Revisions" along with the interpretation, but believe it is an essential component of the guidance to ensure proper and consistent interpretation and implementation. Additionally, if the explanation guidance will be included with the proposed interpretation, we suggest PEEC review the guidance for accuracy. For example, Table C has inconsistent language between the box titled "Entity C" and "Conclusions with respect to Firm E's independence".

Materiality Considerations paragraph states "materiality should be considered in relation to the financial reporting entity and not to materiality as determined at the individual opinion unit." Because opinion units are the governmental equivalent to financial statements as a whole discussed in paragraph 32 of AU-C Section 600, we are unclear on how to develop materiality in relation to the financial reporting entity. If PEEC determines that materiality should be determined "in relation to the financial reporting entity", we suggest additional guidance to more clearly define what that means in a governmental environment.

In regard to certain terms used in the guidance, we believe the term *primary government* should not be used to describe these entities since it conflicts with the Governmental Accounting Standards Board's (GASB) definition. We recommend PEEC utilize a different term that is not already defined in governmental accounting and auditing standards unless its definition is consistent with the pre-existing standards. Similarly, in paragraph 04(c.), PEEC 'broadly defines' *component units* and *funds*, which are both terms previously defined by GASB, as various other entities and activities. To avoid confusion, PEEC may consider using the term 'component' to

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encompass the various downstream entities that are required to be included in the financial reporting entity, consistent with AU-C Section 600, paragraph 11.

We appreciate the efforts of the AICPA Professional Ethics Division and the opportunity to provide our comments. Should you have any questions or need additional information concerning our response, please contact Zach Borgerding or me at (804) 225-3350.

Sincerely,

A handwritten signature in cursive script that reads "Martha S. Mavredes".

Martha S. Mavredes
Auditor of Public Accounts