



October 26, 2017

Ms. Toni Lee-Andrews  
Director, AICPA Professional Ethics Division  
AICPA Professional Ethics Executive Committee  
1211 Avenue of the Americas  
New York, NY 10036-8775

**Re: AICPA Professional Ethics Division, Proposed Interpretation and Other Guidance, State and Local Government Entities (formerly *Entities Included in State and Local Government Financial Statements*)**

Dear Ms. Lee-Andrews:

PricewaterhouseCoopers LLP appreciates the opportunity to provide comments on the AICPA Professional Ethics Executive Committee's (PEEC or the "Committee") proposed interpretation, "State and Local Government Entities" (ET sec. 1.224.020), under the "Independence Rule" (ET sec. 1.200.001) of the AICPA *Code of Professional Conduct* (the "Code of Conduct").

We support the PEEC's efforts to amend the Code of Conduct to strengthen the auditor independence standards and help clarify the client affiliates with respect to which members should maintain independence when performing financial statement attest services for a state or local government (SLG) entity. However, as described below, we believe that, because the proposed interpretation represents such a significant change to the identification of affiliates, it warrants further study and refinement by the PEEC. We believe this is necessary to ensure that the proposal's impact is fully understood and any potential unintended consequences are adequately addressed before final adoption.

**Principal comments and recommendations**

In our view, the proposed interpretation, if adopted, would have a significant impact on auditor independence evaluations, both in terms of expanding the scope of entities subject to evaluation as well as changing the nature of the underlying determinations to identify those entities. We are not aware of evidence that members are misinterpreting or misapplying the current interpretation, "Entities Included in State and Local Government Financial Statements" (ET sec. 1.224.020), or that the current interpretation is inadequate.

*Obtain empirical data to assess the impact of the proposal prior to adoption*

While the current interpretation *generally* requires (with certain exceptions) a member to be independent only of the entity being audited, the proposed interpretation significantly expands the population of entities with respect to which independence is required or must be evaluated. As described in more detail in the Appendix, one of our overarching recommendations is that the PEEC conduct "field tests" of the proposal in order to obtain empirical data to assess the proposal's impact before it is adopted as a final standard. This would give the Committee an opportunity to assess whether the proposed affiliate identification framework (1) is operable in practice, (2) accomplishes the intended results in a manner that causes minimal disruption in the marketplace, and (3) appropriately balances relevant cost/benefit considerations, while achieving the important objective of ensuring auditor independence in the SLG environment.



*Consider utilizing established criteria for assessing affiliate relationships rather than introducing the new concept of “more than minimal influence”*

The current definition of “affiliate” in the Code of Conduct (ET sec. 0.400.02) is based on the existence of a control or significant influence relationship between the financial statement attest client and the client-related entities identified in the definition. This has historically formed the basis for members’ evaluations of entities in relation to which independence must be maintained when performing financial statement attest services. These are concepts that are familiar to the profession and other stakeholders, well-understood, time-tested and pervasive throughout the broad spectrum of auditor independence literature. However, the proposed interpretation does not apply a test based on control or significant influence with respect to “downstream entities” of the financial statement attest client, but instead introduces a new, alternative test that considers the ability of a primary government to exercise “more than minimal influence” over the accounting or financial reporting processes of another SLG entity. As discussed in the Appendix, we question the appropriateness of using this criterion as the basis for the independence analysis.

We recommend that the Committee instead consider employing a concept such as “control” with respect to downstream entities (as is proposed with respect to investments held by the financial statement attest client) as this is an established, widely used, and better understood threshold for determining client affiliations. As such, it would greatly simplify the ability of members and their clients to understand and successfully apply the proposed interpretation.

The Appendix expands on the primary concerns described above, and also offers detailed comments and recommendations regarding other areas of the proposal. Additionally, the Appendix includes our specific responses to the supplementary questions that the PEEC has raised in the exposure draft.

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We would be pleased to discuss our comments and to answer any questions that you or the PEEC may have. If you have any questions regarding this submission, please contact George Dietz at (201) 521-3055.

Sincerely,

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

PricewaterhouseCoopers LLP



## APPENDIX

### Detailed comments and recommendations

#### *Obtain empirical data to assess the impact of the proposal prior to adoption*

The affiliate requirements of the current interpretation are limited, generally scoping in only those entities (i.e., funds, component units, and other entities) that are disclosed in the audited financial statements, with exceptions for those entities with respect to which the primary auditor explicitly states reliance on other auditors' reports. The proposal would greatly expand the provisions of the current interpretation by, among other things, limiting the application of the "reliance on other auditors" exception, and requiring that members undertake independence analyses with respect to upstream entities, certain investments held by the financial statement attest client, and potentially others, such as brother-sister entities. The PEEC has implicitly acknowledged the significance of the proposal by stating in the exposure draft's "Explanation of the Proposed Revisions" (the "explanatory memo") that "members who practice in the SLG environment will need significant time to implement the proposed revisions" (page 22 of the exposure draft). Indeed, the PEEC is recommending an extended effective date of June 15, 2019.

We suggest that further consideration be given to the need for such sweeping changes in practice, particularly if there is no evidence that members are misapplying the current interpretation or that the existing affiliates approach is inadequate. More importantly, given the nature and extent of the revisions being proposed, we believe that it is imperative to fully understand their real-world impact prior to formal adoption of a revised interpretation. Therefore, we recommend that the Committee request that respondents apply, on a volunteer basis, the provisions of the proposed interpretation to one (or more) of their firm's SLG clients (appropriately anonymized). This exercise would identify the real-life implications of the proposal, including whether additional information not already available as a result of financial statement attest procedures is necessary to make the affiliate determinations required by the proposal. This could potentially be done in a manner similar to the pilot testing that the PEEC conducted of the codified version of the Code of Conduct before the codification was exposed for public comment in April 2013<sup>1</sup>.

By soliciting volunteers to undertake this effort, the Committee will obtain empirical data relating to the following key matters:

- The expected impact of the proposal on clients, the marketplace, and on competition;
- Areas of the proposal that are unclear and/or confusing, potentially resulting in misapplication;
- Operational and compliance challenges;
- Cost/benefit implications; and
- Possible unintended consequences (e.g., rotation of auditors due to their unwillingness/inability to comply with the interpretation).

PricewaterhouseCoopers would be happy to participate in this exercise should the Committee agree that this is a necessary effort.

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<sup>1</sup> PEEC Exposure Draft, [Proposed Revised AICPA Code of Professional Conduct](#) (issued April 15, 2013).



*Consider utilizing established criteria for assessing affiliate relationships rather than introducing the new concept of “more than minimal influence”*

In regard to the “Client Affiliates” interpretation (ET sec. 1.224.010) and the related definition of “affiliate” (ET sec. 0.400.02) in the Code of Conduct, the exposure draft’s explanatory memo (page 6) states:

Affiliate guidance does not effectively identify entities requiring independence in the SLG sector because the assumptions of control and significant influence that underpin the guidance in the FASB *Accounting Standards Codification* in the *affiliates* definition is not the basis for inclusion in a governmental financial reporting entity.

To that end, the proposed interpretation relies heavily on financial reporting concepts relevant to the state and local government environment to make conclusions regarding entities with respect to which the member should be independent. The criterion utilized in the proposal for evaluating whether an affiliate relationship exists between a financial statement attest client and other SLG entities is the ability of a primary government (PG) to exercise more than minimal influence (MTMI) over the accounting or financial reporting processes of a fund or component unit (FCU).

As a general point, we do not see a need for the concepts used in independence evaluations to align with financial reporting principles. Rather than introducing the concept of MTMI, which has no precedent in the Code of Conduct, we suggest that the PEEC instead employ criteria that are already established, widely accepted and well understood. In our view, leveraging the concept of “control” would meet this criteria and would greatly simplify the proposed interpretation, as well as align more closely with the general definition of “affiliate” in the Code of Conduct. Although we recognize that “control” is not a GASB financial reporting concept, it is used pervasively in applying the “Independence Rule” (ET sec. 1.200.001) and is referenced in numerous of its interpretations and other auditor independence rule sets. As the purpose of this interpretation is to help members evaluate their independence with respect to affiliates, we believe that utilizing the concept of control is justified even though it is not employed in the GASB’s reporting standards.

In our view, the inclusion of MTMI in the proposal adds an unnecessary degree of complexity to independence evaluations, if simply on the basis of the lack of familiarity that members will have in applying this new threshold. For example, in situations involving group audits, this lack of familiarity with the term may lead to inconsistent application, whereby the group and component auditors could arrive at different assessments of MTMI. As a result, they could reach potentially different conclusions regarding, for example, whether the component auditor has a responsibility to provide a confirmation of independence with respect to the upstream entity.

In addition, control is already cited as the relevant threshold in the exposure draft’s explanatory memo (page 14) with respect to the evaluation of investments:

Specifically, PEEC believes that members should apply the independence rules and related interpretations to certain entities that the financial statement attest client invests in. **PEEC believes the independence rules should be extended to entities in which the financial statement attest client can control the entity...** [emphasis added]

We agree with the use of control in this context, and believe that it should be extended to assessments relating to affiliate relationships in a “downstream” setting.

While we recognize that the GASB’s “reporting entity” definition is not based on the concept of control, we believe that it, nonetheless, may be possible to evaluate affiliate relationships between a PG and its FCUs using the same definition of control applied to evaluating not-for-profit relationships. In that context, the



term “control” is defined as “the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.”<sup>2</sup> This concept could be applied, for example, in a circumstance in which a PG appoints a voting majority of the FCU’s board with the stated intent to establish control, and that appointment is coupled with either imposition of will or a financial benefit/burden. In that circumstance, an affiliate relationship would exist.

We appreciate the arguments often made that, in the governmental environment, control does not apply in the same way that it does in the private sector. Those arguments are based on the premise that the concept of control more closely aligns with ownership and consolidation practices found in the private sector. However, we do not believe that such concerns are relevant for purposes of evaluating independence. In our example in the preceding paragraph, we believe the “intent” to control is irrelevant to independence evaluations. Rather, in our view, the important factor is the “ability” to control. Furthermore, many governmental entities (e.g., governmental hospitals, universities, and utilities) operate in a manner similar to their private sector counterparts with respect to ownership and consolidation practices.

*Consider whether there is a need to address excluded FCUs*

Paragraph .07 of the proposed interpretation requires members to be independent of all material FCUs excluded from the financial statement attest client’s financial reporting entity when the PG has MTMI over the accounting or financial reporting process of those FCUs. The exposure draft’s explanatory memo (page 8) states that “[i]t is not uncommon for a primary government to exclude a fund or component unit from its financial reporting entity for a variety of reasons, such as unavailability of a component unit’s audited financial statements.” In this case, the determinations (e.g., materiality, MTMI) that are required under paragraph .07 of the proposed interpretation cannot readily be made. Although the exposure draft suggests that the exclusion of FCUs from the PG’s financial reporting entity is a common occurrence, our experience suggests otherwise (including because, for example, essentially all state and local government financial statements are public documents, and most are publicly available on the internet). As such, our recommendation is that the Committee consider whether the exclusion of FCUs merits being addressed in the interpretation.

If the PEEC chooses to retain the guidance for excluded FCUs, we suggest expanding the “best efforts” provision in paragraph .13, as discussed below, to also apply to circumstances in which a member is unable to obtain the information necessary from the financial statement attest client to determine whether the PG has MTMI over the excluded FCU’s accounting or financial reporting process, and/or whether that FCU is material to the PG.

*For purposes of evaluating upstream entities, consider whether the use of the term “financial reporting entity” requires further clarification*

Paragraph .09 of the proposed interpretation addresses circumstances in which a material FCU that is a financial statement attest client is required to be included in another financial reporting entity that is not a financial statement attest client. The meaning of the term “financial reporting entity” is unclear as it relates to the specific upstream entities that are within the scope of the required conceptual framework assessment. For example, when a member’s financial statement attest client is a fund, department, or component unit of a state university and that state university is a major enterprise fund of the state government itself, it is unclear whether, for purposes of independence evaluations, the member should treat the state, the university, or both as the “financial reporting entity.” As further described below, the proposed interpretation should be more specific regarding how far upstream in the financial statement attest client’s organizational structure the member needs to apply the conceptual framework.

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<sup>2</sup> FASB Accounting Standards Codification 958, *Not-for-Profit Entities*.



*Consider the implications of requiring a conceptual framework assessment of all relationships with upstream entities*

Paragraph .09 of the proposed interpretation provides that, “[w]hen a material fund or component unit 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, members should use the “Conceptual Framework for Independence” interpretation [ET sec. 1.210.010] to evaluate relationships and circumstances that a member has with a primary government that exerts more than minimal influence over the accounting or financial reporting process of the financial statement attest client.” If the interpretation is adopted as proposed, there would be significant operational hurdles to compliance due to the requirement to evaluate the threats posed by all relationships with and interests in entities that are “upstream” in the organizational structure. Although paragraph .09 may appear to provide a more manageable approach for evaluating independence with respect to upstream entities, that approach would actually result in operational challenges of greater cost and complexity.

Pursuant to the proposal, *all* transactions (implicitly) with upstream entities, irrespective of their significance or materiality, would have to be identified and evaluated to determine whether they may create any threats to independence. These evaluations would presumably have to continue upwards through to the highest reporting entity in the financial statement attest client’s organizational hierarchy, potentially all the way up to the state government itself, including all securities issued by the state government. Additionally, they would have to be undertaken not only at the outset of each relationship with or interest in the upstream entity, but, also, on an ongoing basis in order to monitor whether there has been a change in the significance of any threats to independence. The tracking alone of such relationships and interests would represent a significant effort for most members, particularly those who have a large portfolio of financial statement attest clients in the SLG sector.

As an example, when the financial statement attest client is an academic medical center (i.e., a hospital) and the hospital's upstream entity is a state university, there will generally be a close relationship between the university and the hospital. It would not be difficult for the member performing the financial statement attest services for the hospital to obtain the information necessary to determine whether the hospital is material to the university, or whether the university exerts MTMI over the hospital’s accounting or financial reporting processes. The member should be able to obtain information on the university’s outstanding debt securities in order to evaluate, as required under the proposed conceptual framework approach, the significance of the independence threats created by the member’s financial interests (if any) in such securities.

However, the university is also a component unit of a state government. If, under paragraph .09, a member is required to conduct an independence evaluation at the state government level (or at both the university and state government levels), it would be more challenging for the member to obtain sufficient information about the state government to make the determinations required by paragraph .09 (i.e., materiality, MTMI) because the hospital may likely not have interaction with the state. Additionally, it’s possible that there could be more than three levels in the organizational hierarchy. A member’s financial statement attest client may be a department at a hospital, so the member may have to assess (on an ongoing basis) all relationships with and interests in the hospital itself, the university, and then the state.

Accordingly, we recommend that the PEEC adopt a “knows or has reason to believe” threshold (as is the case in paragraph .10 of the proposed interpretation) for these evaluations, along with specifying that consideration need only be given to entities one level up in the organizational structure from the financial statement attest client. Alternatively, the PEEC could explicitly state that such evaluations are only necessary with respect to material interests and relationships. In either case, we believe some parameters should be established for the requirements of paragraph .09 to be successfully operationalized in a manner that is reasonably cost efficient.





*Clarify the requirement to use the conceptual framework approach*

The “Overview of Financial Interests” interpretation of the Code of Conduct prohibits covered members—such as a partner in the engagement office—from having a direct or material indirect financial interest in a financial statement attest client and its affiliates. Yet, with respect to the conceptual framework approach as described in paragraph .09, the question also arises as to whether a member could reach the conclusion that, for example, a financial interest held by a partner in the engagement office serving the PG does not raise significant independence threats. If the PEEC does not intend for members to comply with the Independence Rule and its interpretations with respect to upstream entities in all circumstances, this paragraph should make that point clearer, rather than invoke the “Conceptual Framework for Independence” interpretation.

The “Conceptual Framework for Independence” interpretation only applies to relationships and circumstances that are not specifically addressed by the “Independence Rule” and explicitly states that the conceptual framework may not be used to overcome “any other prohibition or requirement in an independence interpretation” (ET sec. 1.210.010.02). Therefore, subject to our suggestions above regarding the implementation of a “knows or has reason to believe” or materiality threshold, we believe that paragraph .09 should, at a minimum, be clarified to explicitly require that members evaluate the significance of the independence threats created by relationships with or interests in the PG and apply any necessary safeguards to reduce those threats to an acceptable level, without making reference to the “Conceptual Framework for Independence” interpretation.

*Extend the “best efforts” provision to include all affiliate evaluations*

The “Client Affiliates” interpretation (ET sec. 1.224.010) requires that a member “expend best efforts to obtain the information necessary to identify the affiliates of a financial statement attest client.” If, after expending best efforts, the member is unable to obtain the information to determine which entities are affiliates of a financial statement attest client, the interpretation provides that threats would be at an acceptable level and independence would not be impaired if the member applies certain safeguards (ET sec. 1.224.010.03). This provision applies more broadly than the provision in paragraph .13 of the proposed interpretation to “expend best efforts to obtain the information necessary to identify...investments.” If there is not a compelling reason to deviate from the “Client Affiliates” interpretation in this regard (as noted in the explanatory memo on page 5 of the exposure draft), the PEEC should consider expanding the provision in paragraph .13 to apply to all affiliates of the financial statement attest client generally, but, at a minimum, with respect to upstream entities and “other funds, component units, or activities,” as addressed in paragraph .10 of the proposed interpretation.

*Consider whether the “rebuttable presumption” concept is an accurate characterization*

A “rebuttable presumption” conclusion has been incorporated into paragraph .14 of the proposed interpretation despite the expectation that many entities will not meet the “more than minimal influence” threshold<sup>3</sup>. The PEEC should consider whether the rebuttable presumption concept (i.e., MTMI exists unless proven otherwise) is an accurate characterization or merely a mechanism by which the Committee hopes to force a desired (positive) result. In our view, to retain the rebuttable presumption that MTMI exists when it *generally* may not, has the potential to create a needlessly higher operational hurdle,

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<sup>3</sup> See the explanatory memo of the exposure draft (page 17), which states that “[a]lthough PEEC believes there is a presumption that the primary government has more than minimal influence over its fund’s and component unit’s accounting or financial reporting process, it also believes that this presumption *will often* be rebutted depending upon the specific facts and circumstances.” [emphasis added]



impose excessive and unnecessary compliance costs/activities, and may cause confusion among members, along with other possible unintended consequences.

*Use the term “affiliate”*

The purpose of the proposed interpretation is to identify the entities that are sufficiently related to the financial statement attest client to warrant being treated as the financial statement attest client’s affiliates for independence purposes. Although the explanatory memo (page 6) states that the PEEC “tried to be conceptually consistent with the underlying principles of” the “Client Affiliates” interpretation (ET sec. 1.224.010), the term “affiliate” is not used in the proposed interpretation.

“Affiliate” is a commonly used term in the auditor independence literature, and it is well understood to mean that independence is required of certain entities related to the client. We believe that the absence of this term may cause confusion and potentially lead to misapplication of the proposed interpretation. We suggest that the PEEC revise the proposed interpretation to incorporate a reference to “affiliate” (for example, by way of a parenthetical reference in the introductory paragraph) to make the interpretation’s purpose and effect clearer.

We also recommend that a clarification be made with respect to upstream entities, as addressed in paragraph .09 of the proposed interpretation, regarding the status of these entities as affiliates. Specifically, it should be noted that upstream entities are *not* considered affiliates; meaning, they are not entities with respect to which independence is required in all circumstances. Rather, a “threats and safeguards” evaluation should be undertaken with respect to relationships with and interests in the upstream entity to determine whether threats to independence exist (see our comments and recommendations above with respect to the conceptual framework approach in paragraph .09). The same would hold true for evaluations undertaken with respect to “other funds, component units, or activities,” as discussed in paragraph .10 of the proposed interpretation.

*Make explicit reference to the concept of “nontemporary” as it relates to investments*

The 2nd column in visual aid A of the exposure draft (page 10) refers to the Independence Rule having to be applied to “nontemporary” investments held by the PG. However, this concept is not addressed in the proposed interpretation, except with respect to interests obtained as a result of third party action, in paragraph .04(d)(i). We suggest that consideration be given as to whether the nontemporary criterion should be included in the interpretation, along with guidance as to what constitutes “nontemporary.”

*Explicitly state that investments exclude entities otherwise considered FCUs*

The explanatory memo of the exposure draft (page 15) provides that “[i]nvestments, as defined in the interpretation, exclude entities that would otherwise be considered a fund or component unit.” We recommend that this be stated explicitly in paragraph .04(d) of the proposed interpretation.

*Consolidate guidance in paragraphs .14 and .15 of the proposed interpretation*

Paragraph .15 of the proposed interpretation describes both ends of the spectrum for considering each factor that is relevant to the MTMI evaluation, while paragraph .14 focuses on one end of the range (i.e., that which indicates the primary government has only minimal influence). There appears to be some overlap between these two paragraphs when they are read in combination. Therefore, the PEEC may want to consider combining the two paragraphs into a single list of factors to be considered when assessing whether a PG has MTMI over the accounting or financial reporting process of an FCU.





## Responses to the supplementary questions posed by the PEEC in the exposure draft

- 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.**

It is possible that the proposed affiliate identification framework would not reach the appropriate answer for the general fund. Pursuant to GASB Codification Section 2600.114, the general fund of a blended component unit is required to be presented as a special revenue fund in an upstream entity's financial statements. This might cause confusion pertaining to materiality and MTMI determinations. How this situation figures into the overall independence evaluation should be considered for discussion in the proposed interpretation.

However, there may be other circumstances in which the proposed affiliate identification framework would not be appropriate, with respect to general funds or other SLG entities. For this reason, as recommended above, the Committee should seek volunteers to undertake "field tests" of the proposed interpretation to obtain empirical data that can help the PEEC better assess the adequacy of the framework for general funds and beyond.

- 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?**

In our view, this is another question that would appear to benefit from further study in the form of the field tests that we have recommended in this submission. Having respondents apply the provisions of the proposed interpretation to one (or more) of their firm's SLG clients to identify the affiliates with respect to which the firm would have to follow the "Independence Rule" and its interpretations could yield useful information about whether the existing independence terminology is relevant in the circumstances or has applicable equivalents in the SLG environment. This exercise would help the PEEC determine the necessity of developing additional application guidance in regards to any existing independence terms or concepts.

- 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?**

As described above, the proposed interpretation is unclear, for example, as it relates to the specific upstream entities that are in scope of the required conceptual framework evaluation set forth in paragraph .09. The proposed interpretation should be more specific regarding how far upstream in the financial statement attest client's organizational structure the member needs to apply the conceptual framework.



- 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.**

As described above, we believe that field tests of the proposed interpretation would be the best approach to gather data about whether additional information not already available as a result of other financial statement attest procedures is necessary to make the MTMI determinations required by the proposal.

- 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?**

See our comments above on utilizing established criteria for assessing affiliate relationships rather than introducing the new concept of “more than minimal influence.”

- 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?**

See our comments above on extending the “best efforts” provision to include all affiliate evaluations.

- 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 do not believe it is always clear to which entity the interpretation would apply when grant funds are involved. For example, we believe additional guidance would be needed to address a situation involving a state grant made to a state component unit, such as a state university, hospital, or utility. In such cases, the proposed interpretation might apply to entities that are funds or component units of the financial statement attest client, depending on the resolution of the matters discussed in this comment letter. One of the factors that might have to be considered in a threats and safeguards evaluation is whether the source of the state grant is (a) state funding, or (b) federal funding that the state redistributes, often referred to as “pass-through grants.”